LEGISLATIVE BUDGET ANALYSIS

2005 Special Session

Presented to the Fifty-ninth Legislature

Submitted by

The Legislative Fiscal Division

Helena, Montana

December 14, 2005

Legislative Fiscal Division

www.leg.mt.gov/css/fiscal

MONTANA LEGISLATIVE BRANCH

Legislative Fiscal Division

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Legislative Fiscal Analyst
CLAYTON SCHENCK

December 14, 2005

Members of the 59th Legislature:

In accordance with 5-12-302, MCA, I submit for your consideration the Legislative Fiscal Division budget analysis for the December 2005 special session. It is our goal that this report provide the fiscal information necessary to assist committees and legislators as you deliberate the fiscal issues on public school funding and unfunded liabilities in the state pension funds as included in the Governor's special session call.

This report includes the following:

- Background information on the events leading to a special session
- A summary of the Governor's special session call and budget proposal
- Background information and a review of the school funding issue
- Background information and a review of the Retirement Systems unfunded liability issue
- A detailed summary of the general fund revenue estimates as adopted by the Revenue and Transportation Interim Committee
- A projection of the General Fund balance as of the end of the 2005, 2007 and 2009 biennia, including an analysis of structural balance of the general fund in the 2009 biennium

Your staff of the Legislative Fiscal Division look forward to being of service to the legislature during this special session. We are here to assist legislators in obtaining the best possible fiscal information for making the difficult decisions that lie ahead. Please feel free to call on us to assist you in your deliberations.

Respectfully submitted,

Clayton Schenck
Legislative Fiscal Analyst

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INTRODUCTION

PURPOSE OF REPORT

The 59th Legislature has been called into special session to deal with a proposal to add funding for K-12 education in order to comply with a court order that found the pre-2007 biennium level of funding inadequate. The session call also addresses the unfunded liability in Montana pension funds. The purpose of this report is to provide to the legislature:

- A summary of the Governor's special session call and budget proposal
- Background information and a review of the school funding issue
- Background information and a review of the retirement systems unfunded liability issue
- A detailed summary of the general fund revenues estimates as adopted by the Revenue and Transportation Interim Committee
- A projection of general fund balance as of fiscal year end 2005, 2007 and 2009

As noted throughout this report, there are a number of volatile economic conditions that may change the final outcome of revenue and budget projections for the 2007 and 2009 biennia. Of primary concern is the uncertainty of individual income tax and oil and gas production collections, which have shown growth patterns that are unusual and need further analysis. This report will be updated as needed should revenue projections or expenditure considerations change significantly prior to and during the special session.

BACKGROUND – HOW DID WE GET HERE?

The 59th Legislature faced a daunting challenge in the 2005 regular session. In response to a December 2004 Supreme Court preliminary decision that declared the current method of funding K-12 education unconstitutional, the legislature was faced with the requirement to: 1) define a basic system of quality schools; 2) "cost out" the resources required to deliver a basic system of quality education; 3) develop a funding formula to distribute budget authority among school districts; and 4) develop the revenue stream to pay for the funding formula. The Supreme Court issued a final order in March 2005 affirming the district court's decision (Sherlock) that the legislature provide a plan to remedy the school-funding problem by October 1, 2005.

The 59th Legislature achieved the objective in the 2005 regular session of defining a basic system of quality schools, but decided that more time was needed to research and determine the costs of a basic system of quality education and to construct a funding formula for distribution of the state share of the cost. In SB 525, the Legislature established a Quality Schools Interim Committee (QSIC) to "assess the educational needs of Montana's children, determine the costs of a basic system of free quality public elementary and secondary schools, determine the state's share of the costs, and construct a funding formula that equitably distributes the state's share of the costs of the basic system". The QSIC was charged to complete its work by December 1, 2005, with the understanding that a special session would be called, most likely in December 2005, to implement a plan and funding mechanism for schools that fully met requirements of the court order.

The QSIC commissioned a team of nationally recognized experts to conduct a study of the cost of an adequate K-12 education, and the results of their research showed that, using four different methods, the cost could require from $0 to $340 million in additional funding per year. Another study determined that teacher recruitment and retention was a problem for smaller schools. The committee then developed a new funding formula and adopted staff recommendations on consolidating funds, and directed staff to develop a bill reflecting the new funding formula. In its final form, the bill would have cost $100 million more per year in base aid. The draft bill was not adopted by the QSIC, as they determined that the new formula required additional work.

On the same morning that the QSIC met to deliberate the draft bill (December 5), the Governor held a press conference and, citing that the QSIC had not agreed on it's draft bill, declared that he would call the legislature into special session on December 14 to address the school funding issue as well as an unfunded liability in state defined benefit pension plans and other issues. The Governor proposed his own plan and formula for funding public schools to be considered by the legislature in special session (see page 5).

THE GOVERNOR'S CALL

The Governor's call to the 59th Legislature for a special session is presented in its entirety in Appendix A of this report.

In summary, The Governor's call limits the special session to the following issues:

1. Legislation to enact a funding system for public schools that is based on the definition of a quality education in SB 152 and that fulfills the requirements of the Supreme Court's decision in *Columbia Falls Elementary School vs. State of Montana.*
2. An appropriation for the schools funding system enacted in the special session in compliance with the Supreme Court's holding.
3. Appropriations of one-time general fund money to public schools for recognition of the cultural heritage of American Indians and for facility studies, weatherization for long-term energy savings, deferred maintenance, and assistance with utility and transportation energy costs.
4. An appropriation of $100 million general fund to the teacher's retirement system and $25 million to the public retirement system to reduce the unfunded liability of the systems.
5. To consider the State Administration and Veterans' Affairs Interim Committee sponsored bill (LC 2006-2) that provides for legislative committee monitoring of the state retirement systems and review of proposed pension system legislation.
6. A revenue estimate resolution as submitted by the Revenue and Transportation Interim Committee.
7. Confirmations of the chief water judge, the workers' compensation judge, and the Governor's vacancy appointment of the director of the Department of Public Health and Human Services.
8. The "feed bill" appropriation for the operations of the special session.

The Governor's budget proposal for appropriations to fund items 2 through 4 above is $190 million general fund and is contained in House Bill 1. The Governor's budget proposal is summarized in the next section of this report.

GOVERNOR'S BUDGET PROPOSAL

INTRODUCTION

The Governor's proposal for the special session is shown below and described in more detail later in the report. Overall, the proposal includes $64.9 million general fund for school funding and $125 million general fund for the retirement systems, $100 million of which is for the Teachers Retirement System. These appropriations will be contained in HB 1 and total $189.9 million. Of that amount, $158.5 million is considered "one-time only".

Governor also included in the call legislation (HB 2), which expands the responsibilities of the State Administration and Veterans Affairs (SAVA) Interim Committee to include duties related to the monitoring of the retirement systems and review of legislative proposals affecting the retirement systems. HB 2 contains an appropriation of $5,000 general fund.

SCHOOL FUNDING

The Executive's proposal for K-12 funding for the 2005 Special Session includes $31.4 million in ongoing BASE aid funding and $33.5 million in one-time funding for FY 2007. Numbers shown do not exactly match those in HB 1 as introduced. These totals consist of the following items:

ONGOING SPENDING

Quality Educator Component		
All Districts (calculated 13 ANB per educator)	$22,691,000	
Very Small Districts (calculated as 13 ANB Educator)	431,000	
Sub-total		$23,122,000
Close American Indian Achievement Gap Component		1,639,600
Indian Education for All Component		3,002,430
At Risk Component (Based on Title 1 Formula)		2,500,000
Retirement Impact (County)		1,139,895
Total Ongoing Spending		$31,403,925

ONE-TIME ONLY SPENDING

Indian Education for All Component	$7,000,000
Building Operation and Maintenance	22,998,633
Energy Cost Relief	1,008,053
Facility Condition Inventory	2,500,000
Total One-time Spending Provision	$33,506,686
Total K-12 Proposal	$64,910,611

See School Funding – LFD Analysis at page 5 for more details on the Executive's K-12 funding proposal.

RETIREMENT SYSTEMS

The special session call includes two items that relate to the retirement systems unfunded liabilities, totaling $125 million general fund, and legislation to provide for monitoring of retirement systems by a legislative committee:

CASH INFUSION TO RETIREMENT SYSTEMS

Teachers Retirement System	$100,000,000
Public Employee Retirement System	25,000,000
Total One-Time Appropriation	$125,000,000

MONITORING AND REVIEW OF RETIREMENT SYSTEMS

SAVA Interim Committee Monitoring of Systems	$5,000

The SAVA committee is the State Administration and Veterans Affairs Interim Committee. For further information, see "Retirement Systems Unfunded Liability – LFD Analysis" on page 11.

SCHOOL FUNDING – LFD ANALYSIS

BACKGROUND

In March 2005, the Montana Supreme Court unanimously upheld the April 2004 district court decision (the Sherlock Decision) that found the K-12 funding system unconstitutional because the legislature did not define a basic system of quality elementary and secondary schools, did not have a school funding formula based on educationally relevant factors; and because the legislature had not adequately funded education of all Montana children in the cultural heritage of American Indians.

In response, the 2005 legislature did the following:

1. Defined a basic system of quality elementary and secondary schools in SB 152.
2. Created the Quality Schools Interim Committee in SB 525 to devise a new funding formula that reflects the new definition and determines the state share of K-12 funding.
3. Appropriated $3.4 million for Indian Education for All.
4. Appropriated $68.8 million in additional Base Aid for the FY 2007 biennium above FY 2004 levels by increasing the per ANB entitlements by $250 per elementary ANB and by $100 per high school ANB; by instituting three-year averaging of ANB, and applying inflation to the basic and per ANB entitlements.
5. Appropriated an additional $16.5 million for other categorical programs.

QUALITY SCHOOLS INTERIM COMMITTEE

The Quality Schools Interim Committee (QSIC) created in SB 525 met 21 times after the end of the 2005 session and accomplished the following:

1. Commissioned a team of nationally recognized experts to conduct a study of the cost of an adequate K-12 education using 4 methods. The results showed that the K-12 system requires between $0 and $340 million in additional funding.
2. Commissioned a team of economists from Montana State University to study teacher recruitment and retention problems in Montana. The study found recruitment and retention problems for small schools but not for large schools.
3. Directed staff to develop a new funding formula comprising 6 general fund components (including a per student component, a classroom component, an accredited program component, an operations and maintenance component, a special education component, and an Indian education for all component), and 3 non-general fund components (a debt service component, a capital projects component, and a transportation component).
4. Adopted staff recommendations on consolidating funds.
5. Directed staff to draft a bill reflecting its work in developing a new funding formula based on educationally relevant factors.

In its final form, the new formula would have cost the state $100 million more per year in Base Aid. Some of the features of the new formula were adopted in modified form in the Governor's proposal.

The bill drafted became LC 0001. It was not adopted by the committee, who determined that the new funding formula required more work.

GOVERNOR'S K-12 PROPOSAL

On December 5, 2005, Governor Schweitzer introduced a proposal for additional general fund of $64.9 million K-12 funding for FY 2007. The financial analysis is shown in Figure 1.

Figure 1

Financial Analysis of SB1 - K-12 Proposal - FY07 - Senator Ryan

	Ongoing Spending	Units	Cost per Unit	Total Cost	State Share	Local Share
	Quality Educator Component					
	All Districts (calculated 13 ANB per Educator)	11,345.5	$2,000.00	$22,691,000	$22,691,000	$0
	Very Small Districts (calculated as 13 ANB per Educator)	215.5	$2,000	$431,000	$431,000	0
1	Total Quality Educator Component	11,561.0	$2,000	$23,122,000	$23,122,000	$0
2	Close American Indian Achievement Gap Component	16,396	100	1,639,600	1,639,600	0
3	Indian Education For All Component	147,161	20	3,002,430	3,002,430	0
4	At Risk Component (Based on Title I Formula)			2,500,000	2,500,000	0
5	Retirement Impact (County)			4,221,832	1,139,895	$3,081,937
	Total Ongoing Spending Provisions			$34,485,862	$31,403,925	$3,081,937
	One-Time Only Spending					
6	Indian Education for All Component	147,161	$ 47.57	$7,000,000	$7,000,000	$0
7	Building Operation and Maintenance	$1,000/Dist - $154/ANB		22,998,633	22,998,633	0
8	Energy Cost Relief	147,161	6.85	1,008,053	1,008,053	0
9	Facility Condition Inventory (Dept of Admin)			2,500,000	2,500,000	0
	Total One-Time Spending Provisions			$33,506,686	$33,506,686	$0
	Total K-12 Proposal			$67,992,548	$64,910,611	$3,081,937
	Total Distributed to School Districts			$61,270,716	$61,270,716	$0
	Total Distributed to Counties (Retirement)			$4,221,832	$1,139,895	$3,081,937
	Total Distributed to Dept of Admin (FCI Study)			$2,500,000	$2,500,000	$0
	Total K-12 Proposal			$67,992,548	$64,910,611	$3,081,937

The Governor's proposal is divided between items that are ongoing and those that are one time. All of the proposals are funded by the state general fund. There should be no district property tax increases compared to what would have happened in the absence of the new state money. There may be property tax decreases if districts so choose. However, if districts use the money to hire new educators or raise salaries of existing educators, there will be a county retirement cost, and thus property taxes for county retirement will increase.

ONGOING PROPOSALS

1. Creation of a Quality Educator component in the district general fund at $2,000 per educator for all districts and an additional $2,000 for districts with less than 41 ANB. The state's cost is $23.0 million.

a. The regular educator component is for all districts and is calculated by dividing the ANB of a district by 13, and rounding to the nearest tenth. Each district receives at least one educator entitlement. There are 11,321.1 calculated educators statewide.
b. The number of educators in the educator component for very small schools (less than 41 ANB) is 191.1. Districts may receive a fractional part of one of these entitlements.

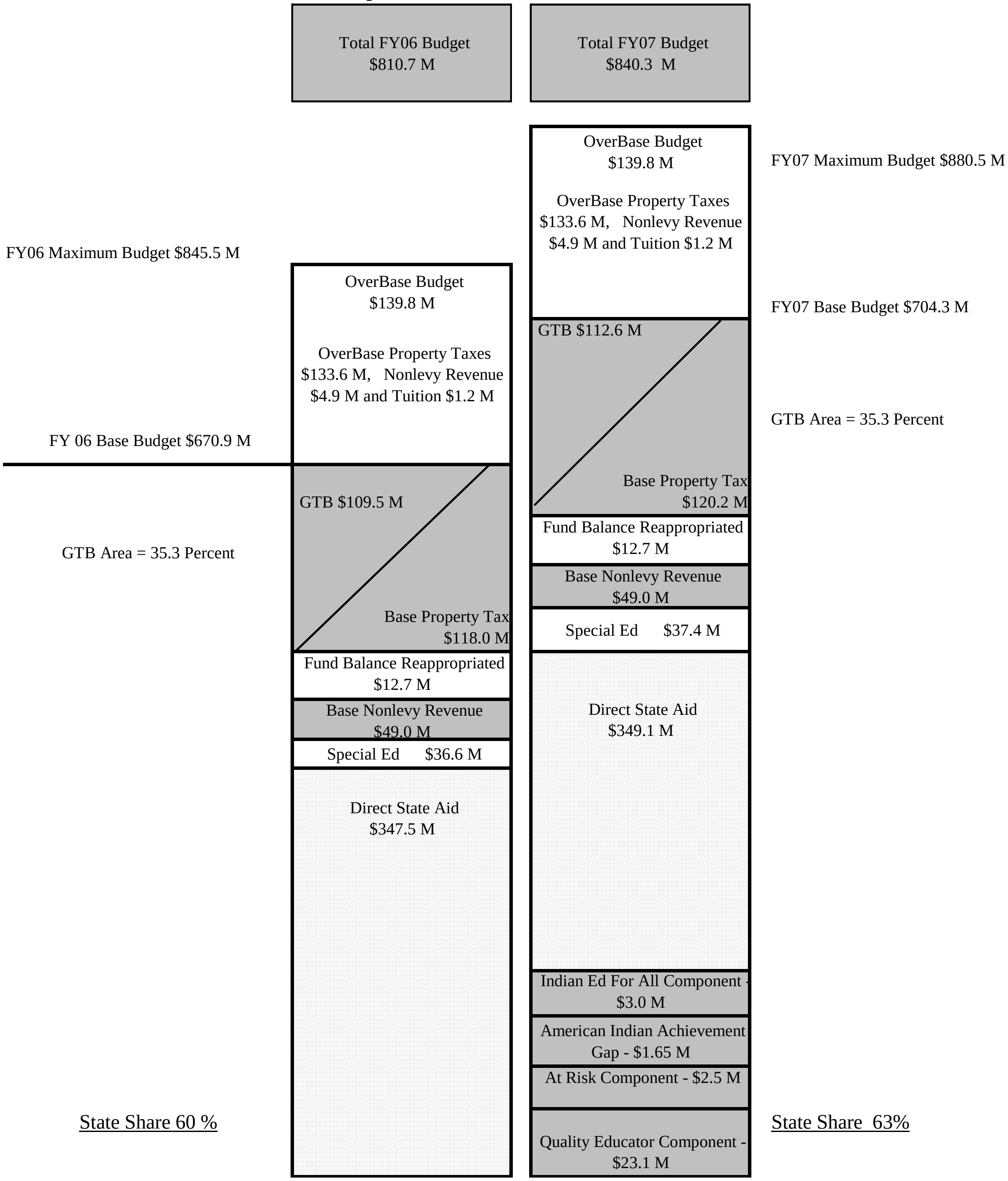
LFD ISSUE The QSIC determined that student teacher ratios differ markedly by size of school district. In FY 2006, the number of students per regular education teacher varied from 8.5 in very small districts to 18.7 in the largest districts. Under the Governor's proposal, very small districts receive $4,000 per educator for every 13 children, while small districts (mostly Class C with 41 ANB – 150 ANB) receive $2,000 per educator for every 13 children. Class C districts have actual student teacher ratios of 11.7 at the elementary level and 12.5 at the high school level, and thus will be funded for fewer regular educators than actually exist. This is true for no other size category.

2. Creation of a component to close the American Indian achievement gap - $1.65 million. This will be distributed to districts with American Indian students of which there are 16,396 in FY 2006. The per student amount is $100.
3. Creation of a component for Indian Education for All - $3.0 million. The proposal distributes $20.40 for every ANB in the state, with a minimum of $100 per district. There are expected to be 147,161 ANB in FY 2007.
4. Creation of a component for at-risk children - $2.5 million. This component will be distributed based on the formula by which federal Title 1 monies are distributed. This formula is based on the percentage of children in a district below the federal poverty line.
5. If the dollars associated with these components are used by districts for new hires or for salary increases there will be a need for increased social security, Medicare, workers compensation, and teachers retirement contributions. At maximum this could total $4.2 million, of which the state share is $1.1 million and the portion paid for by county property taxes is $3.1 million.
6. Abolishment of the sunset date of June 30, 2007 for ending three year averaging of ANB. The proposal also makes permanent the per ANB increases in HB 63 enacted in the 2005 session. HB 63 increased the FY 2005 per ANB entitlements for FY 2006 by $250 per elementary ANB and by $100 per high school ANB, but also sunset these provisions at the end of FY 2007 by returning the per ANB entitlements to FY 2005 levels.

The ongoing proposals are shown visually in Figure 2 on the following page. The box on the left shows the district general fund budget and revenue in FY 2006. The box on the right shows the same box for FY 2007 with the Governor's proposal. The general fund budget box is increased by the amount of the 4 new components, $31.3 million, all of which are paid for by state dollars.

Figure 2

Comparison of FY06 District General Fund Budget and FY07 District General Fund Budget Under the Governor's Proposal - Adds $30.3 Million to District General Fund



Also shown in Figure 3 is a comparison of the Governor's proposal with the FY 2004 Base and the FY 2007 appropriated amount. The Governor's proposal does not change base aid in FY 2007 but adds the 4 new components.

Figure 3

Comparison of Governor's K-12 Proposal to Base FY04, Current Law 2007 Biennium, Ongoing State General Fund Costs

(Amounts in Millions)

Component	FY2004 Base	FY 2007 Appropriations	Increase in FY 2007 over FY 2004 Base	2007 Appropriations Plus Governor's Proposal - FY 2007	Increase in 2007 Appropriations and Governor's Proposal Over FY 2004	Percent Increase Over FY 2004
Base Aid	$449.5	$485.5	$35.9	$485.5	$35.9	
Special Ed	34.9	39.3	4.5	39.3	4.5	
School Facilities	8.3	10.4	2.1	10.4	2.1	
Other (HB 124 BG, Vo-Ed, Gifted & Talented)	64.2	66.1	1.9	66.1	1.9	
Per Educator	0.0	0.0	0.0	23.1	23.1	
Close American Indian Achievement Gap	0.0	0.0	0.0	1.6	1.6	
Indian Education For All Component	0.0	0.6	0.6	3.0	2.5	
At Risk Component (Based on Title I Formula)	0.0	0.0	0.0	2.5	2.5	
Retirement Impact (County)	0.0	0.0	0.0	1.1	1.1	
Total Cost	$556.9	$601.9	$45.0	$632.8	$75.3	14%

ONE-TIME PROPOSALS

1. Creation of a component for Indian Education for All - $7.0 million. This component is distributed at $47.57 for every ANB in the state.
2. Creation of a component for building operation and maintenance (for weatherization and deferred maintenance) - $23.0 million. This component is distributed $1,000 per district and $154 per ANB.
3. Creation of a component for energy cost relief - $1.0 million. This component is distributed at $6.85 for every ANB in the state and may be used for fuel costs or other energy needs.
4. Allocation of $2.5 million to the Department of Administration to conduct an inventory of the condition of each school building in the state.

In total the amount distributed to districts from the state under the Governor's proposal is expected to be $61.2 million. The maximum amount by which county retirement costs may go up is $4.2 million, of which the state share is expected to be $1.1 million. Finally, $2.5 million is allocated to the Department of Administration to conduct a facility condition inventory. The total cost of the Governor's proposal is expected to be $64.8 million in FY 2007.

LFD ISSUE The property tax impact of the Governor's proposals is uncertain. County retirement property taxes will certainly increase, but the amount is uncertain and it could be as high as $3 million. However, it is possible that district property taxes will decline in those jurisdictions who choose to reduce district property taxes with the state dollars received under the proposal.

LFD ISSUE The Sherlock decision ruled that the current K-12 funding formula (containing a basic entitlement and a per ANB entitlement) was unconstitutional because: 1) it was based on spending data two years old at its implementation; 2) the entitlement amounts were not based on educationally relevant factors; 3) it relies too much on ANB; and 4) it contains no inflation factor. The Governor's proposal does nothing about items 1 and 2. However, the legislature in the 2003 session added provisions to inflate the entitlements starting in FY 2006. The US consumer price index is used to accomplish this. Also, in the 2005 legislative session, the legislature adopted three-year averaging of ANB, which attempted to address the problem in item 3.

LFD ISSUE The Governor's proposal adds $3 million in Indian Education for All on an ongoing basis and $7.0 million on a one-time basis. No justification for these amounts is given although these are the same amounts recommended by the QSIC. However, the recommended dollars to close the American Indian achievement gap are only $1.65 million and $2.5 million for at-risk students. The QSIC recommended spending $7.7 million on an ongoing basis for all at risk students. It seems unlikely that the proposed amount of money will do much to close the American Indian achievement gap, especially since the average spending per student on reservation schools in FY 2004 was close to $19,000.

RETIREMENT SYSTEMS UNFUNDED LIABILITY - LFD ANALYSIS

The Governor's special session call includes three items related to the public employee retirement systems:

- An appropriation of $100 million from the general fund to the teachers' retirement system to both reduce the unfunded liability of the system and to help improve Montana's ability to recruit and retain qualified teachers
- An appropriation of $25 million from the general fund to the public retirement system to help reduce the unfunded liability of the system
- LC 2006-2, approved by the State Administration and Veterans' Affairs Interim Committee on November 30, 2005

BACKGROUND

UNFUNDED LIABILITY OF PERS, TRS, SRS, AND GWPORS

The issue before the legislature is the unfunded liabilities in the following retirement systems:

- PERS – Public Employees Retirement System
- TRS – Teachers' Retirement System
- SRS – Sheriffs' Retirement System
- GWPORS – Game Wardens' and Peace Officers' Retirement System

An "unfunded liability" refers to the excess of a retirement plan's *actuarial liability* over the *actuarial value of assets*. *Actuarial liability* is the amount that the retirement system expects to pay out over the long-term. *Actuarial value of assets* is the amount that the retirement system expects to have available to pay retirement obligations over the long-term. Both components of the equation are based upon many assumptions.

Unfunded liabilities are reported for retirement systems other than the four listed above, but the amortization period for those other systems is less than 30 years as required in statute. In simpler terms, this means that the actuarial unfunded liability for the other systems is calculated to theoretically disappear in less than 30 years. The Judges Retirement System is the only plan that does not have an unfunded liability. The four retirement systems listed above, on the other hand, have actuarial unfunded liabilities that are not amortized in less than 30 years, as Montana statute requires for the retirement plan to be actuarial sound.

How Much is the Unfunded Liability?

Based on the actuarial valuations prepared as of June 30, 2005, the total unfunded actuarial liability for the four systems was estimated at $1.46 billion. Broken out by retirement plan, the unfunded liabilities are as follows:

- PERS - $541.8 million
- SRS - $10.9 million
- GWPORS - $5.5 million
- TRS - $903.3 million

Article VIII, Section 15 of the Montana Constitution provides that "Public retirement systems shall be funded on an actuarially sound basis". This constitutional requirement drives the need for the state to address the issue of an unfunded liability to insure that funds are available in the future to meet the obligations of future benefits as determined by actuarial valuations of the retirement systems. This requirement is further defined in Section 19-2-409, MCA:

> *"…"actuarially sound basis" means that contributions to each retirement plan must be sufficient to pay the full actuarial cost of the plan. For a defined benefit plan, the full actuarial cost includes both the normal cost of providing benefits as they accrue in the future and the cost of amortizing unfunded liabilities over a scheduled period of no more than 30 years."*

To satisfy the 30-year amortization requirement, the legislature does not need to provide the entire $1.46 billion. What is needed is a plan to reduce the unfunded liability to a level that can be amortized within the 30 years, either by increasing the system's assets (cash infusion), increasing the revenue into the system (contributions or investment earnings), and/or reducing the expenditures from the system (reducing benefits). The solution must provide a plan to pay down the unfunded liability within 30 years, and the retirement funds could then be viewed as "actuarially sound".

Where did the Unfunded Liability Come From?

Investment losses are the primary reason for the current unfunded liability problem. In the period of 2001 through 2003, those returns were much lower than projected, and in two of the three years were negative. The drop in value of the equity market (stocks) is the major culprit.

To the degree that reported actuarial surpluses were used up by the passage of benefit enhancement legislation without increased contributions to fund them, unfunded retirement benefit increases have contributed to the present situation. Such legislation was enacted in the years preceding the decline in the equity markets, particularly legislation that increased the guaranteed annual benefit adjustment (GABA) to its current level of 3 percent per year.

It should be pointed out that investment gains, contribution rate increases, and reamortization of unfunded liabilities have historically been used by legislatures all across the country to fund benefit enhancements. Montana is not alone in funding benefits using enhanced market values, nor is it alone in having experienced significant investment losses. Montana is also not the only state seeking solutions to actuarially fund its public pension plans.

SAVA COMMITTEE RECOMMENDATIONS

In the 2005 legislative session, the State Administration and Veterans Affairs (SAVA) interim committee was assigned the study related to the unfunded liability that was directed in HJR 42. Within the context of this study, the SAVA committee has developed recommendations to address the "unfunded liability" problem, in the form of two bill drafts:

- LC2006-2 - This bill would direct the SAVA interim committee to monitor the soundness of the state's public retirement systems and to review all legislative proposals for statutory changes. The bill details the additional duties and responsibilities of the committee and provides a $5,000 general fund appropriation to fund the increased costs for the committee to meet for an additional two days. The added duties and responsibilities mirror those of the Committee on Public Employees Retirement Systems that existed from 1993 through 1998. The SAVA committee concluded that this function should be reestablished with the legislature to ensure that the legislature has the opportunity to review retirement system proposals. This bill draft is specifically included in the Governor's special session call.
- LC2005-4 - This bill would provide the statutory changes and appropriate funds necessary to achieve the actuarial soundness of the four public retirement systems. The bill addresses the unfunded liability in three ways:
  - Appropriations to provide an infusion of cash into the four retirement plans in FY 2006 – totaling $125 million general fund (as drafted), $100 million of which is earmarked for the teachers system. The bill would appropriate $10.9 million to the PERS defined benefits plan, $11.5 million to the SRS, $1.2 million to the GWPORS, and $1.4 million to be used for repaying the loan for startup costs of the defined benefits plan.
  - Increases in employer contribution rates for three systems beginning July 1, 2006 (note that the employer rate for the GWPORS is not increased because the $1.2 million that is paid into that system provides an amount needed to reduce the unfunded liability to a level where the plan is actuarially sound). Several sections provide for the employer contribution rate increases for PERS, SRS, and TRS plans. For the SRS, there is a single rate increase beginning July 1, 2006, from 9.535 percent to 10.205 percent, along with a cash infusion of $11.5 million. For the PERS and the TRS plans, the employer rate increases are phased in beginning July 1, 2006. These rate increases would stay in place until eliminated or changed by the legislature based upon actuarial valuations for the retirement plans, showing that the plans were actuarially sound. Within the appropriations clause is a placeholder for appropriations to fund these rate increases.
  - Housekeeping modifications to close loopholes in the retirement laws that increase the unfunded liability.

In all, this bill (LC2005-4) would provide a financial solution to the current unfunded actuarial liability (UAL) issue by putting a plan in place to bring the amortization period for the UAL to within 30 years. However, only a portion of this bill is included in the special session call…that being the cash infusion of $125 million general fund.

LFD COMMENT If the legislature chooses to address the unfunded liability of the Game Warden and Peace Officers Retirement System (GWPORS) with a $1.2 million appropriation, state special revenue might be justified for a portion of the amount. As an example, about 18 percent of the payroll reported for GWPORS is for game wardens. Game warden salaries are paid from state special revenue, largely from the Department of Fish, Wildlife, and Parks general license account. Therefore, it seems logical that the game warden share of the appropriation be from the same source. The appropriation from the general license account would be $216,000, with the result that $216,000 general fund of the proposed $1.2 million could then be applied elsewhere. Other non-general fund sources could be examined as well. In order to appropriate from the general license account or any other state special revenue source for this purpose in the special session, the special session call would need to be expanded.

GOVERNOR'S PROPOSAL

The Governor's proposal, as represented in the special session call, is quite simple. First, the proposal suggests enactment of legislation (LC2006-2) to give the State Administration and Veterans Affairs interim committee the additional duties and responsibilities relative to the monitoring of the public employee retirement systems.

Second, the proposal suggests the appropriation of $125 million general fund to reduce the unfunded liability of the retirement plans. One call item suggests consideration of "an appropriation of $100 million from the general fund to the teachers' retirement system to both reduce the unfunded liability of the system and to help improve Montana's ability to recruit and retain qualified teachers". Another call item suggests consideration of "an appropriation of $25 million from the general fund to the public retirement system to help reduce the unfunded liability of the system". According to the Governor's Office of Budget and Program Planning, the legislation being prepared on behalf of the Governor intends the $25 million to be specifically for the Public Employees Retirement System, and not the Sheriffs Retirement System or the Game Wardens and Peace Officers Retirement System, or the payoff of the startup loan suggested by the SAVA committee bill. Legislative legal staff indicates that, under the call, the legislature would be able to appropriate the $25 million general fund either way.

LFD COMMENT A call by a governor for a special session is purposefully limited for various reasons. In this instance, it should be pointed out that the two items relating to the unfunded liability issue represent only part of the solution that was recommended by the State Administration and Veterans Affairs (SAVA) interim committee in its November 30, 2005 meeting. Besides the $125 million general fund cash infusion, the SAVA committee legislation includes the phasing-in of employer contribution rate increases and changes to statute that would close some loopholes in the calculation of benefit levels. The cost of the phased-in employer rates is estimated at about $15.3 million <u>all funds</u> in FY 2007, $31.6 million in FY 2008, $32.8 million in FY 2009, $41.0 million in FY 2010, and then a more normal growth of about 4.5 percent after that for many years thereafter. If the legislature wishes to pursue the SAVA committee's recommendations, an expansion of the call will be necessary.

OPTIONS FOR LONG-TERM RESOLUTION OF UNFUNDED LIABILITY

The National Conference on State Legislatures (NCSL) prepared a report titled "Pension and Retirement Plan Enactments in 2005 State Legislatures". From this report, several different actions taken by various states have been identified, which the Montana legislature might consider. These actions are intended to either increase the money going into the system to pay down the unfunded liability or reduce the unfunded liability by lowering the cost of benefits paid in the future.

Potential actions include:

- Shift from a defined benefit plan to a defined contribution plan for new hires. An action to replace the defined benefits plan with the defined contribution plan for all new hires would not change the unfunded liability that exists. It does however remove from the defined benefit plan those new members that would be contributing to reducing the unfunded liability. It has the effect of increasing the "normal costs" of paying benefits because without new employees to replace the retiring employees, fewer and fewer active employees are contributing to the system. Therefore, actuarial assumptions would have to change, resulting in a need for another revenue source, most likely employer contribution increases.
- Modify retirement eligibility and benefit calculations for new hires, such as increasing age and service requirements, or reducing the multiplier applied in the calculation to arrive at the benefit level. Currently, for PERS as an example, the multiplier is 1.78571 percent of [average annual salary times years of service] for persons retiring with up to 25 years of service. Persons retiring with 25 years or more have a multiplier of 2 percent.
- Increase the number of years used for the final average salary calculation for new hires. Currently, PERS uses a 3 year average of 3 highest consecutive annual salaries. Some states have changed their calculation to use 5 years or 7 years. This has the effect of leveling out the salaries and mitigates a "spike in salary" that can result in higher, but unfunded, benefit increases.
- Limit the percent increase in salary allowed for the benefit calculation for new hires. Again, this would mitigate "spikes" in salaries.
- Increase the employee contribution for new hires.
- Increase the employer contribution for all active members. Because contributions are a product of payroll, which is funded by various sources, this option spreads the costs among the various fund sources (general fund, state special revenue, federal funds, and proprietary funds).
- Avoid early retirement incentives.
- For early retirement incentives, have the employer pay the resulting unfunded liability.
- Have retirement system members contribute an additional percentage toward an early retirement plan (refundable if not used).
- Close loopholes, such as salary spiking and creative return to work provisions. The Teachers Retirement System has proposed some of these type of changes in the SAVA bill draft.
- Issue general obligation bonds using proceeds to pay down the liability. In preliminary estimates, when compared to the alternative of increasing employer contribution rates, it appears significantly less costly to pay the debt service than to pay the increased payroll costs over a thirty-year period. Other questions that should be considered is how the debt service payments would be funded (can all fund sources be accessed for debt service), and how would issuing this much debt affect Montana bond ratings and interest rates?

Some states have made changes to reduce benefits or increase employee contributions, but Legislative Services Division legal staff has indicated on different occasions that the Montana Legislature does not have this option, based upon a constitutional argument concerning the existence of an employment contract which the legislature cannot alter by passing a law (see Article II, Section 31 of the Montana Constitution).

LFD COMMENT Any of the options listed above, and possibly others, might be viable solutions for Montana. Of those listed, only the increased employer contribution rates and closing loopholes were included in the legislation that the State Administration and Veterans Affairs interim committee recently recommended. These two options could be included in a special session solution (if the call is expanded to do so), because they have been considered in the context of a whole solution and have met actuarial review. Other options have not had the same level of review and probably should, in the spirit of the SAVA bill (LC2006-2) that establishes a structure for review of such proposals, be delayed to the regular session. This would give the legislature sufficient time to explore the options for actuarial soundness and unintended consequences.

SUMMARY

The proposals in the Governor's special session call related to the public employee retirement systems, include an action to reinstate an interim legislative process for the monitoring of the retirement plans and review of proposed legislation to change those plans. This proposal is consistent with the recommendation of State Administration and Veterans Affairs (SAVA) interim committee, and can provide the legislature with a structure for a fuller understanding of the impacts of legislation on the actuarial soundness of the retirement systems.

The call also suggests a proposal to appropriate $100 million general fund as a cash infusion into the Teachers Retirement System and $25 million general fund into the Public Employee Retirement System. This is consistent with only part of the recommendation set forth by the SAVA committee as a whole solution to the unfunded liability problem for the four public employee retirement systems that are not considered actuarially sound at this time. In addition to the $125 million, the SAVA committee recommended increased employer contribution rates and the closing of some loopholes in the calculation of benefits.

If the legislature wishes to enact the broader solution, it will need to seek an expansion of the special session call. In the absence of a broader solution, these retirement plans will continue to be actuarially "unsound" in violation of the Constitution and state law.

GENERAL FUND ANALYSIS

INTRODUCTION

This chapter provides a detailed analysis of the state's general fund since the 2005 regular legislative session, including a progression from the ending fund balance for the 2005 biennium, the revised revenue estimates for the special session revenue estimating resolution, and the resulting projected fund balance at the end of the 2007 and 2009 biennia. It also includes a projection of structural balance of the general fund in the 2009 biennium for the purpose of assessing sustainability of ongoing appropriations in the special session.

To assist the reader in locating the section(s) that are of particular interest, the following provides a reference to specific topics in this chapter.

2005 BIENNIUM GENERAL FUND PROJECTION

After completion of the 59th Legislature, the unreserved ending general fund balance for the 2005 biennium was projected to be $162.4 million (Figure 1). This balance was based on: 1) revenue estimates adopted in HJR 2; 2) LFD statutory appropriation and reversion estimates; 3) all general fund appropriations authorized by the legislature; and 4) the estimated impacts of all enacted revenue legislation. The 59th Legislature did not budget for any supplemental or emergency appropriations.

As Figure 1 shows, the revised unreserved general fund balance at the end of the 2005 biennium is now projected to be $297.4 million. This revised projection is based on preliminary fiscal 2005 information provided by the statewide accounting system (SABHRS). This projected balance equals 10.2 percent of anticipated revenues for the 2005 biennium and is $135.0 million above the balance anticipated after adjournment of the 59th Legislature.

Figure 1

Comparison of 2005 Biennium General Fund Balance Post Session Fiscal Report vs. Current LFD Analysis (In Millions)	Fiscal Report 2005 Biennium	LFD Analysis 2005 Biennium	Difference 2005 Biennium
Beginning Fund Balance	**$43.065**	**$43.065**	**$0.000**
Revenues			
Current Law Revenue	2,779.161	2,912.514	133.353
Total Funds Available	**$2,822.226**	**$2,955.579**	**$133.353**
Disbursements			
General Appropriations	2,401.183	2,401.390	0.207
Statutory Appropriations	255.260	255.189	(0.071)
Non-Budgeted Transfers	22.465	19.564	(2.901)
Anticipated Reversions	(26.549)	(40.078)	(13.529)
Total Disbursements	**$2,652.359**	**$2,636.065**	**($16.294)**
Adjustments	(7.429)	(22.074)	(14.645)
Projected Ending Fund Balance	**$162.438**	**$297.440**	**$135.002**

The increase in the projected general fund balance is primarily due to revenue collections being higher than anticipated by the 59th Legislature. Preliminary total general fund revenues are $133.4 million more than anticipated, while disbursements were $16.3 million less than authorized by the legislature. Fund balance adjustments were a negative $14.6 million.

REVENUE ESTIMATES AND COLLECTIONS

Column 2 of Figure 2 shows the fiscal 2005 revenue estimates for the general fund account as adopted in HJR 2 during the 2005 legislative session as adjusted for enacted legislation. The adjacent columns in the table show actual collections, the amount collections were over or (under) the estimate, the percent difference, and the contribution percent. The contribution percent signifies the importance of each revenue component to the general fund account. For example, individual income taxes were 46.2 percent of the total general fund collections, while wine taxes accounted for only 0.10 percent during fiscal 2005. This column of information shows that about 70.7 percent of general fund revenue collections in fiscal 2005 came from individual (46.2%), property (10.9%), vehicle (7.2%), and corporate (6.4%) taxes.

Figure 2

General Fund Receipts By Major Component Fiscal 2005					
Revenue Category	Estimated 2005 Receipts *	Actual 2005 Receipts	Over(Under) Estimate	Percent Difference	Contribution Percent
GF0100 Drivers License Fee	$2,958,000	$3,373,220	$415,220	14.04%	0.22%
GF0200 Insurance Tax	59,272,000	57,308,425	(1,963,575)	-3.31%	3.75%
GF0300 Investment Licenses	4,464,000	5,192,327	728,327	16.32%	0.34%
GF0400 Vehicle License Fee	80,360,000	80,132,416	(227,584)	-0.28%	5.24%
GF0500 Vehicle Registration Fee	31,730,000	30,639,380	(1,090,620)	-3.44%	2.00%
GF0600 Nursing Facilities Fee	5,855,000	5,913,086	58,086	0.99%	0.39%
GF0700 Beer Tax	2,933,000	2,936,880	3,880	0.13%	0.19%
GF0800 Cigarette Tax	34,608,000	35,116,847	508,847	1.47%	2.30%
GF0900 Coal Severance Tax	9,105,000	10,311,856	1,206,856	13.25%	0.67%
GF1000 Corporation Tax	66,332,000	98,213,717	31,881,717	48.06%	6.42%
GF1100 Electrical Energy Tax	4,295,000	4,074,409	(220,591)	-5.14%	0.27%
GF1150 Wholesale Energy Trans Tax	3,485,000	3,370,263	(114,737)	-3.29%	0.22%
GF1200 Railroad Car Tax	1,585,000	1,604,005	19,005	1.20%	0.10%
GF1300 Individual Income Tax	614,736,000	706,234,580	91,498,580	14.88%	46.19%
GF1400 Inheritance Tax	3,701,000	4,190,613	489,613	13.23%	0.27%
GF1500 Metal Mines Tax	4,483,000	5,264,276	781,276	17.43%	0.34%
GF1700 Oil Severance Tax	58,206,000	62,625,939	4,419,939	7.59%	4.10%
GF1800 Public Contractor's Tax	1,748,000	1,410,831	(337,169)	-19.29%	0.09%
GF1850 Rental Car Sales Tax	2,593,000	2,565,554	(27,446)	-1.06%	0.17%
GFXXX Property Tax	169,370,000	167,270,350	(2,099,650)	-1.24%	10.94%
GF2150 Lodging Facilities Sales Tax	10,113,000	10,200,914	87,914	0.87%	0.67%
GF2200 Telephone Tax	0	31,657	31,657		0.00%
GF2250 Retail Telecom Excise Tax	21,307,000	21,144,420	(162,580)	-0.76%	1.38%
GF2300 Tobacco Tax	3,677,000	4,024,017	347,017	9.44%	0.26%
GF2400 Video Gaming Tax	52,932,000	53,361,007	429,007	0.81%	3.49%
GF2500 Wine Tax	1,436,000	1,502,601	66,601	4.64%	0.10%
GF2600 Institution Reimbursements	16,082,000	12,508,688	(3,573,312)	-22.22%	0.82%
GF2650 Highway Patrol Fines	4,104,000	4,292,730	188,730	4.60%	0.28%
GF2700 TCA Interest Earnings	9,174,000	10,046,531	872,531	9.51%	0.66%
GF2900 Liquor Excise Tax	11,125,000	11,468,432	343,432	3.09%	0.75%
GF3000 Liquor Profits	6,608,000	6,650,000	42,000	0.64%	0.43%
GF3100 Coal Trust Interest Earnings	33,892,000	36,751,940	2,859,940	8.44%	2.40%
GF3300 Lottery Profits	7,273,000	6,222,555	(1,050,445)	-14.44%	0.41%
GF3450 Tobacco Settlement	2,871,000	2,977,777	106,777	3.72%	0.19%
GF3500 U.S. Mineral Leasing	26,878,000	27,293,725	415,725	1.55%	1.79%
GF3600 Other Revenue	28,304,000	34,722,736	6,418,736	22.68%	2.27%
Total Current Year Revenue	$1,397,595,000	$1,530,948,704	$133,353,704	9.54%	100.14%
Prior Year Adjustments	0	(2,105,948)	(2,105,948)		-0.14%
Residual Equity Transfers	0	0	0		0.00%
Total Revenue	$1,397,595,000	$1,528,842,756	$131,247,756	9.39%	100.00%

* House Joint Resolution 2 estimates as adjusted for enacted legislation.

At the bottom of Figure 2, prior year adjustments and residual equity transfers are shown, providing a complete picture of the total revenue flow in the account.

Figure 3 General Fund Revenue Recap Fiscal 2005					
Account	Revenue Category	Estimated Receipts*	Fiscal 2005 Receipts	Over (Under) Estimate	Diff. Percent
01100	General Fund Receipts	$1,397,596,000	$1,530,948,704	$133,352,704	9.54%
---	Prior Year Adjustments	0	(2,105,948)	(2,105,948)	
---	Residual Equity Transfers	0	0	0	
	Totals After Adj. & Trsf.	$1,397,596,000	$1,528,842,756	$131,246,756	9.39%

* House Joint Resolution 2 estimates as adjusted for enacted legislation.

Figure 3 shows aggregate revenue estimates and collections for the general fund account. The 59th Legislature adopted a total fiscal 2005 general fund account revenue estimate of $1,397.6 million. The Legislature did not anticipate any prior year adjustments or residual equity transfers. Total collections (including adjustments and transfers) were $1,528.8 million or $131.2 million (9.4 percent) above the estimated amount.

Total current year revenue collections (before prior year adjustments) were $133.3 million above the amount anticipated by the 59th Legislature. The legislature did not include any prior year revenue adjustments in HJR 2. Since this type of revenue is the result of revenue accruals and/or uncollected previous years' receipts, it would be difficult to include an estimated amount in the state budget. As shown in Figures 2 and 3, however, prior year revenue adjustments were a negative $2.1 million. Most of these adjustments were due to actual revenues received in July and August of fiscal 2005 being different than the accrued amounts booked during fiscal year end 2004. While most revenue categories include prior year revenue adjustments, individual income and property taxes accounted for a significant portion of prior year activity.

Figure 3A Reasons for Changed Revenue Receipts Fiscal 2005 (In Millions)		
Revenue Source	Amount	Preliminary Explanation
Individual Income Tax	$91.5	Audits, non-wage income growth
Corporation Income Tax	31.9	Audits, delayed refunds,profit growth
FEMA Reimbursement Accrual	5.5	Unanticipated reimbursement
Oil & Natural Gas Production Tax	4.4	Commodity price and production
Coal Trust Interest Earnings	2.9	Interest rates
Coal Severance Tax	1.2	Commodity price and production
Vehicle Tax/Fee	(1.3)	Vehicle growth and legislation
Lottery Profits	(1.1)	Reduced ticket sales
Insurance Tax	(2.0)	Reduced fee collections
Property Tax	(2.1)	Accounting change
Instituition Reimbursements	(3.6)	Medicare and accounting change
All Other Categories	6.1	-
Total Change	$133.4	

Figure 3A summarizes which major sources of revenue exceeded or were below expectations and provides a brief explanation of why collections were different than anticipated. As shown, individual and corporation income taxes were the primary sources responsible for increased revenue collections. A number of insignificant issues caused the majority of the revenue reductions. The next section of the report provides a brief explanation for the changes in collections.

Individual Income Tax - $91.5 million

Individual income tax collections for fiscal 2005 were $91.5 million above estimates contained in HJR 2 as adjusted for enacted legislation. This amount represents a 16.7 percent increase above fiscal 2004 collections. The 59th Legislature assumed the growth rate to be 1.6 percent above the fiscal 2004 amount.

Figure 3B shows the accounting details of individual income tax collections for fiscal 2005 compared to fiscal 2004. Withholding taxes, which are an indicator of wage growth, grew by 5.3 percent - lower than the growth in wage and salary income seen from the 2004 tax return data of 5.8 percent.

Figure 3B
Individual Income Tax Comparison

Revenue Code & Description	Actual Fiscal 2004	Actual Fiscal 2005	Difference	Percent Change
510101 Withholding Tax	474,851,498.28	501,230,798.36	26,379,300.08	5.26%
510102 Estimated Tax	152,143,812.91	199,884,808.59	47,740,995.68	23.88%
510103 Current Year I/T	103,283,893.97	134,284,266.54	31,000,372.57	23.09%
510105 Income Tax - Audit Collections	29,922,459.00	37,240,150.93	7,317,691.93	19.65%
510106 Income Tax Refunds	(154,853,243.51)	(166,405,444.62)	(11,552,201.11)	6.94%
Totals	$605,348,420.65	$706,234,579.80	$100,886,159.15	16.67%
Percent of Actual/Estimated	100.00%	114.88%		

Figure 3B also shows that estimated and current year payments are above the previous year's amount by 23.9 percent and 23.1 percent, respectively. Three non-wage income components (dividends, capital gains, rents/royalties/partnership incomes) for tax year 2004 were higher than anticipated in HJR 2. All the remaining components of income, when combined, were very close to the estimated amounts contained in HJR 2.

***Corporation Income Tax** - $31.9 million*

Corporation income tax revenues in fiscal 2005 were $98.2 million, $31.9 million or 48.1 percent greater than projected in HJR 2 as adjusted for enacted legislation. Two known factors played a critical role in the increased corporation tax revenues. First, the fiscal 2005 estimate assumed $8.4 million of unusual refunds would be issued. Based on discussions with the Department of Revenue (DOR), these refunds have not occurred but are expected to be issued within the 2007 biennium. Second, the HJR 2 estimate included anticipated audit collections of $3.0 million. Actual audit receipts were about $10.6 million. According to the DOR, there were no unusually large audits in fiscal 2005. Another factor that has positively influenced corporation taxes is the improvement in the national economy since "9/11") and the 2002 recession. The increase in corporate profits at the national level has been significant and it is assumed that Montana has benefited from this improvement.

***FEMA Reimbursement Accrual** - $5.5 million*

During the 2004 wildfire season, the state expended money suppressing wildfires on lands under federal jurisdiction. Although it is a lengthy process, the state is eventually reimbursed for the expenditures. During the fiscal 2005 year-end closing process, the Department of Natural Resources and Conservation booked a $5.5 million accrual of anticipated reimbursement of wildfire costs from the Federal Emergency and Management Agency for fiscal 2004. This accrual was not included in the HJR 2 estimate.

***Oil & Natural Gas Production Tax** - $4.4 million*

Oil and natural gas productions taxes are driven by the amount of production and the price received for the commodities. Based on information from tax reports, the production of oil and natural gas and the average price per barrel of oil and MCF of natural gas exceeded HJR 2 estimates in fiscal 2005. The oil and natural gas industry in Montana has been undergoing major changes. Improved techniques have allowed new fields to be developed and old fields to be more productive. In particular, oil production from the Elm Coulee field and natural gas production from the CX field have been large factors in the production increase. Nationwide, energy prices had been increasing as has prices for Montana oil and natural gas.

Coal Trust Interest Earnings - *$2.9 million*

Coal trust interest earnings are generated from the investment of the coal severance tax trust fund corpus. By statute, coal trust investment earnings not earmarked to other programs are deposited to the general fund. The earning rate on the trust funds bond pool (a large majority of the trust's balances is invested in the pool) for fiscal 2005 was an average 6.8 percent, which exceeded the HJR 2 estimate of 6.4 percent.

Coal Severance Tax - *$1.2 million*

The coal severance tax is driven by the amount of production and the price received for the commodity. Based on tax return data, both coal production and contract sales prices are above the amounts contained in HJR 2. The combination of higher production and prices increased revenues above the estimated amounts contained in HJR 2.

Vehicle Tax/Fee - *($1.3 million)*

Motor vehicle tax and fee revenue for fiscal 2005 was expected to increase 0.68 percent from fiscal 2004. This growth rate was premised on the number of vehicles increasing by 3.0 percent. Fiscal 2005 collections were actually less than collections in fiscal 2004. Either the growth in vehicles did not materialize or the effects of enacted legislation were not accurately estimated. More current data from the Department of Justice will be available in January.

Lottery Profits - *($1.1 million)*

Lottery profits are the result of ticket sales less commission and operating costs, and payouts. Transfers of lottery profits to the general fund were less than anticipated in HJR 2 because Powerball ticket sales were down approximately 30 percent. According to the lottery director, reduced sales were due to fewer large jackpots than in previous years.

Insurance Tax - *($2.0 million)*

Insurance tax revenues is the combination of insurance fees and the tax levied on premiums. Based on preliminary information, the fee collections were less than anticipated by about $1 million. The State Auditor has been contacted for an explanation of the reduction.

Property Tax - *($2.1 million)*

The 2005 legislature enacted Senate Bil1 87 that required the transfer of half of the protested taxes already collected in fiscal 2003 and 2004 from the general fund to a new state special revenue account. Although a transfer of $2.6 million from the general fund in fiscal 2005 was indicated in the fiscal note, the DOR deposited $3.1 million of protested taxes directly to the state special revenue account instead. This reduced property tax revenue deposited in the general fund by $3.1 million and increased state special property tax revenue by the same amount. The net impact on the general fund ending balance was zero.

Institution Reimbursements - *($3.6 million)*

Public institution reimbursement revenue is composed of private, insurance, Medicaid, and Medicare payments to state owned facilities. In fiscal 2005, revenue collections were $3.6 million lower than projected in HJR 2 as adjusted for enacted legislation. The reduction in anticipated revenues can be explained, in large part, by the repayment of a fiscal 2004 overpayment of Medicare reimbursements of $1.0 million. Additionally, the Medicare reimbursement rate was reduced mid-fiscal year to prevent a repeat of this situation in fiscal 2005, further reducing reimbursements. The repayment represents a one-time occurrence and is not expected to negatively affect future revenue collections.

The Department of Public Health and Human Services also made an accounting change that reduced expected accruals by over $1 million. The change in accounting practices will only have negative revenue effects in fiscal 2005 and should not impact future years.

All Other Sources - *$6.1 million*

The combined change from the HJR 2 estimates for the remaining revenue sources is $6.1 million. Some revenue sources were above the HJR 2 estimate while others were below the estimate. In total, the net change was $6.1 million more than anticipated.

DISBURSEMENTS AND REVERSIONS

Figure 4 shows general fund account disbursements and reversions for fiscal 2005. General fund current year disbursements (excluding non-budgeted and prior year activity) were $23.2 million below budgeted amounts. Total reversions $23.2 million minus non-budgeted disbursements of $6,094 and prior year expenditure adjustments of $10.9 million were $12.2 million. Since total reversions budgeted by the 59th Legislature were $6.9 million, “unexpected” reversions were $5.3 million ($12.2 million - $6.9 million = $5.3 million).

Figure 4
General Fund Account
Disbursements and Reversions
Fiscal 2005

Account	Category	Budgeted Amount*	Fiscal 2005 Disbursements	Over (Under) Budget	Diff. Percent
01100	General Fund Disbursements	$1,377,187,000	$1,354,020,411	($23,166,589)	-1.68%
---	Non-Budgeted Disbursements	0	6,094	6,094	na
---	Prior Year Exp. Adjustments	0	10,942,304	10,942,304	na
	Total Disbursements	$1,377,187,000	$1,364,968,809	($12,218,191)	-0.89%
---	Reversions	($6,866,000)	($12,218,191)	($5,352,191)	

* General fund disbursements are before adjustments for budgeted reversions of $6.9 million.
Total reversions were $12.2 million or $5.4 million more than budgeted.

Although unexpected reversions were $5.3 million, this amount is skewed by unexpected prior year disbursements of $10.9 million. About $9.1 million of this amount was due to fiscal 2004 adjustments for wildfire costs ($5.6 million) and US mineral royalty transfers ($3.5 million). Additionally, not all of the reversion amount will truly revert since $2.4 million of the reversion amount has been re-established as continuing and carry-forward appropriations in fiscal 2006. These appropriations are expected to be expended by the end of the 2007 biennium.

The primary agencies with significant reversions were the Legislative Branch ($4.2 million), Office of Public Instruction ($8.5 million), Department of Revenue ($3.8 million), and Department of Public Health and Human Services ($2.0 million).

FUND BALANCE ADJUSTMENTS

During fiscal 2005, there were direct adjustments to the fund balance and SABHRS to GAAP reconciliation items. Direct fund balance adjustments increased the general fund account ending fund balance by about $0.7 million (shown in Table 1).

SUMMARY OF FISCAL 2005 INFORMATION

As stated earlier, the preliminary general fund account unreserved, undesignated ending balance for fiscal 2005 is $297.4 million, or $135.0 million above the level anticipated by the 59th Legislature. The reasons, as previously discussed, are summarized in Figure 5.

Figure 5
Reasons for General Fund Balance Change
Fiscal 2005 (In Millions)

Explanation of Fund Balance Change	Amount
Revenue Collections (Actual - Estimated)	133.4
Prior Year Revenue Adjustments	(2.1)
Disbursements (Budgeted - Actual)	16.3
Prior Year Expenditure Adjustments	(10.9)
Fund Balance Adjustments	(1.6)
Total Change	**$135.1**

2007 BIENNIUM GENERAL FUND OUTLOOK

INTRODUCTION

The state's financial picture is probably the most optimistic budget situation the state has faced in a number of years. Not only are anticipated revenues significantly above the level of funding needed to fund the level of services authorized by the 59th Legislature, the projected ending fund balance for the current biennium is well above an ending fund balance reserve advocated by national experts. Because this balance is so high, the special session legislature should be mindful of the structural balance in the 2009 biennium before these funds are used to implement policies that will require additional funding in subsequent biennia.

However, large federal deficits, pension unfunded liabilities, labor negotiations, rising health care costs, bulging corrections populations and national economic uncertainties could be significant budget "busters" as the biennium proceeds. With the prospect of further federal tax reform, the continued threat of terrorism attacks, and the on-going US war with Iraq makes the job of developing prudent revenue estimates an extremely difficult task. Artificially low estimates may cause the legislature to reduce or restrain state services that fall below the legislature's priority line. Estimates that are too high may create the temptation for the legislature to fund state services that the state cannot afford. Obviously, the last scenario would result in spending reductions by the executive and/or a special session.

As delineated in Section 5-18-107(1) (a), MCA, the Revenue and Transportation Interim Committee (RTIC) is required to prepare "an estimate of the amount of revenue projected to be available for legislative appropriation." In addition, sections 5-12-302(2) and 5-12-307(7) specifically require the Legislative Fiscal Analyst (LFA) to "estimate revenue from existing and proposed taxes" and also requires the LFA to "assist the revenue and transportation committee in performing its revenue estimating duties...".

The following section addresses the actions of the RTIC on December 13, 2005. It should be noted that the accompanying committee recommendations are based on current federal and state laws and do not include estimates for revenues due to litigation or any other pending legal issues. This position is consistent with past recommendations of the RTIC.

REVENUE AND TRANSPORTATION INTERIM COMMITTEE ACTION

At the September 30, 2005 meeting, the RITC directed LFD staff to provide revised general fund revenue estimate recommendations to the committee in anticipation of a special legislative session. Since a majority of the difference between fiscal 2005 actual collections and HJR 2 revenue estimates (adjusted for legislation) was due to individual income and corporation income taxes, and to some degree, oil and natural gas production taxes, the committee directed staff to limit their review and potential adjustments to only the economic assumptions and the associated revenue estimates for these three sources. As had been done in the past, the committee also directed LFD staff to calculate the associated impact on US mineral royalty and common school interest and income revenues provided an adjustment was adopted for oil and natural gas price and production levels. The one exception to the above direction was for property tax. Because the committee felt taxable values of property classes were essential to the development of a new public school funding formula, it directed staff to review property tax taxable value assumptions. Even though the Quality Schools Interim Committee did not recommend school funding legislation for the special legislative session, staff provided updated property tax estimates based on known taxable values for tax year 2005 (fiscal 2006). All other revenue sources remained as contained in HJR 2 as amended by the 59th Legislature.

Based on LFD staff recommendations, the figure below shows the revised revenue estimates adopted by RTIC for fiscal 2006 and 2007 for the general fund account. Information provided includes the original HJR 2 plus legislation estimate, the revised estimate, and the difference for each year of the 2007 biennium. As shown in the figure, the committee is recommending the general fund estimates be increased by $121.7 million in fiscal 2006 and $131.3 million in fiscal 2007 for a biennial adjustment of $253.0 million.

Common school interest and income estimates, which are non-general fund revenues, are recommended to be adjusted by $9.9 million in fiscal 2006 and $8.0 million in fiscal 2007 for a biennial increase of $17.9 million.

House Joint Resolution 2 Plus Legislation Impacts
General Fund Revenue Estimates
In Millions

			Fiscal 2006			Fiscal 2007			2006-2007 Biennium			
	Source of Revenue	Percent Biennium	HJR 2 Plus Legislation	Spec. Sess. Recommend.	Change	HJR 2 Plus Legislation	Spec. Sess. Recommend.	Change	HJR 2 Plus Legislation	Spec. Sess. Recommend.	Change	Cumulative % of Total
1	Individual Income Tax	44.29%	607.178	677.815	70.637	630.060	712.611	82.551	1,237.238	1,390.426	153.188	44.29%
2	Property Tax	11.44%	173.804	176.391	2.587	180.062	182.900	2.838	353.866	359.291	5.425	55.73%
3	Oil & Natural Gas Production Tax	6.11%	61.192	99.410	38.218	64.958	92.554	27.596	126.150	191.964	65.814	61.84%
4	Corporation Income Tax	6.01%	81.148	91.427	10.279	78.997	97.281	18.284	160.145	188.708	28.563	67.85%
5	Vehicle Tax	5.17%	80.140	80.140	-	82.050	82.050	-	162.190	162.190	-	73.02%
6	Insurance Tax & License Fees	4.02%	61.580	61.580	-	64.637	64.637	-	126.217	126.217	-	77.04%
7	Video Gambling Tax	3.58%	55.031	55.031	-	57.509	57.509	-	112.540	112.540	-	80.62%
8	Motor Vehicle Fee	2.29%	35.029	35.029	-	36.960	36.960	-	71.989	71.989	-	82.92%
9	Cigarette Tax	2.07%	33.069	33.069	-	31.790	31.790	-	64.859	64.859	-	84.98%
10	Coal Trust Interest	2.05%	32.211	32.211	-	32.290	32.290	-	64.501	64.501	-	87.04%
11	All Other Revenue	1.82%	27.389	27.389	-	29.601	29.601	-	56.990	56.990	-	88.85%
12	US Mineral Royalty	1.74%	26.712	26.712	-	27.962	27.962	-	54.674	54.674	-	90.59%
13	Telecommunications Excise Tax	1.40%	21.700	21.700	-	22.101	22.101	-	43.801	43.801	-	91.99%
14	Public Institution Reimbursements	0.96%	15.127	15.127	-	15.049	15.049	-	30.176	30.176	-	92.95%
15	Treasury Cash Account Interest	0.87%	13.102	13.102	-	14.367	14.367	-	27.469	27.469	-	93.82%
16	Liquor Excise & License Tax	0.75%	11.535	11.535	-	11.959	11.959	-	23.494	23.494	-	94.57%
17	Lodging Facility Use Tax	0.70%	10.715	10.715	-	11.419	11.419	-	22.134	22.134	-	95.28%
18	Coal Severance Tax	0.54%	8.466	8.466	-	8.644	8.644	-	17.110	17.110	-	95.82%
19	Lottery Profits	0.50%	7.844	7.844	-	7.839	7.839	-	15.683	15.683	-	96.32%
20	Liquor Profits	0.44%	6.786	6.786	-	7.017	7.017	-	13.803	13.803	-	96.76%
21	Nursing Facilities Fee	0.37%	5.851	5.851	-	5.824	5.824	-	11.675	11.675	-	97.13%
22	Metalliferous Mines Tax	0.34%	5.236	5.236	-	5.438	5.438	-	10.674	10.674	-	97.47%
23	Highway Patrol Fines	0.33%	5.042	5.042	-	5.324	5.324	-	10.366	10.366	-	97.80%
24	Investment License Fee	0.30%	4.598	4.598	-	4.736	4.736	-	9.334	9.334	-	98.10%
25	Electrical Energy Tax	0.27%	4.276	4.276	-	4.270	4.270	-	8.546	8.546	-	98.37%
26	Tobacco Tax	0.24%	3.779	3.779	-	3.847	3.847	-	7.626	7.626	-	98.62%
27	Wholesale Energy Tax	0.23%	3.520	3.520	-	3.555	3.555	-	7.075	7.075	-	98.84%
28	Beer Tax	0.19%	2.986	2.986	-	3.039	3.039	-	6.025	6.025	-	99.03%
29	Driver's License Fee	0.18%	2.784	2.784	-	2.792	2.792	-	5.576	5.576	-	99.21%
30	Public Contractors Tax	0.18%	3.030	3.030	-	2.522	2.522	-	5.552	5.552	-	99.39%
31	Rental Car Sales Tax	0.18%	2.704	2.704	-	2.820	2.820	-	5.524	5.524	-	99.56%
32	Tobacco Settlement	0.15%	2.319	2.319	-	2.309	2.309	-	4.628	4.628	-	99.71%
33	Railroad Car Tax	0.10%	1.574	1.574	-	1.562	1.562	-	3.136	3.136	-	99.81%
34	Wine Tax	0.10%	1.487	1.487	-	1.538	1.538	-	3.025	3.025	-	99.91%
35	Estate Tax	0.09%	1.950	1.950	-	0.939	0.939	-	2.889	2.889	-	100.00%
	Total General Fund	100.00%	$1,420.894	$1,542.615	$121.721	$1,465.786	$1,597.055	$131.269	$2,886.680	$3,139.670	$252.990	100.00%
	Common School Interest & Income		$57.149	$67.013	$9.864	$56.233	$64.225	$7.992	$113.382	$131.238	$17.856	

REVENUE ESTIMATE DETAIL

The following section of this report contains revenue estimate recommendations by RTIC for five revenue sources:

1. Corporation Income Tax
2. Individual Income Tax
3. Oil and Natural Gas Production Tax
4. Property Tax
5. Common Schools Interest & Income

A profile for each of the above revenue sources contains 10 categories of information. These categories and a short description of each follow:

Revenue Description: A brief description of the source is provided including the origin of the revenue and, in the case of taxes and fees, the item that is taxed.

Applicable Tax Rate(s): This section provides an explanation of the tax rate or license fee, more detail on the items that are taxed, and other information such as exemptions, minimums, initial versus annual fees, etc.

Distribution: This section shows how the revenue is distributed. In cases where uses or entities other than general fund receive a portion of the revenue, percentage distribution or the dollar amount is shown for each recipient.

Collection Frequency: Timing of the revenue deposited in the state treasury may affect the revenue estimate. Most revenue is usually received on a quarterly or monthly basis.

Statutory Reference: These are the citations from the Montana Code Annotated (MCA) applicable to the revenue source and include citations for the tax rate, the distribution, and when the tax is due.

Additional Information Since Adjournment: A general description of changes that have impacted the specific revenue source since the 59^{th} Legislature adjourned.

Revenue Projection: This section consists of a graph and accompanying data table. The line graph shows the amount of actual collections and the projected amounts for fiscal years 2006 and 2007. Total collections are depicted by a dark line while general fund collections are shown by a lighter line. The data table contains historic information about this data source since 1983 including: 1) actual total collections; 2) actual general fund collections; 3) projected total and general fund amounts for fiscal 2006 and 2007; and 4) the yearly percentage change in general fund.

HJR 2 Comparison: This section includes a table that shows the HJR 2 revenue estimate, the RTIC revenue estimate recommendations, and the difference between the two estimates for fiscal 2006, 2007 and a biennium total.

CORPORATION INCOME TAX

Revenue Description:

The corporation income tax is a license fee levied against a corporation's net income earned in Montana. The corporation income tax is imposed on corporations that, for reasons of jurisdiction, are not taxable under a license tax. Factors that affect corporation license tax receipts include tax credits and the audit efforts by the Department of Revenue. As with individual income tax, all forecasts are adjusted for allowable credits.

Applicable Tax Rate(s):

The tax rate is 6.75%, except for corporations making a "water's edge" election (see 15-31-322, MCA), who pay a 7.0% tax on their net income.

Distribution:

Prior to the enactment of SB 442 by the 2005 legislature, the Department of Revenue could distribute up to 0.45% of this general fund revenue source as an administrative assessment to a state special revenue account to pay debt service on the loan used to fund a POINTS replacement computer system (enacted in Senate Bill 271 by the 2003 legislature). SB 442 eliminated this provision. Beginning fiscal 2006, all corporation tax revenue is distributed to the general fund.

Collection Frequency:

Monthly, Quarterly, and Annually

Statutory Reference:

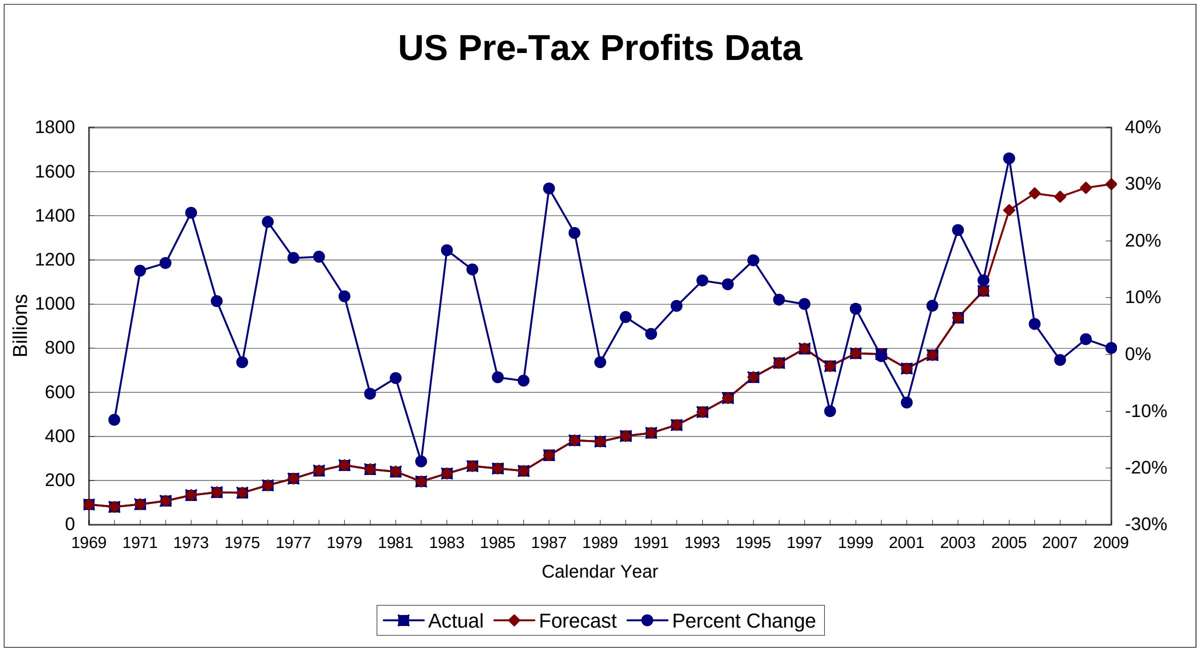
Tax Rate (MCA) – 15-31-121,
Tax Distribution (MCA) – 15-31-121, 15-1-501(1)
Date Due – by the 15th day of the fifth month following the close of the corporate fiscal year (15-31-111, 15-31-502). Estimated taxes due April 15th, June 15th, September 15th, and December 15th (15-31-502).

Additional Information Since Adjournment:

The corporation tax estimates are recommended to increase by $28.6 million, or 17.8 percent, over the HJR 2 estimates for the 2007 biennium. Since the last legislative session, new data has shown higher corporation tax collections. An additional year of data from both the state accounting, budgeting, and human resource system (SABHRS) and return data from the Department of Revenue (DOR) shows a dramatic increase in collections for this source. The recommendations are $91.4 million in fiscal year 2006 and $97.3 million in fiscal year 2007.

Total corporation tax collections are expected to increase to $99.8 million in fiscal year 2006, but a carry-over of $8.4 million in unusual refunds is anticipated to reduce the total collections. The refunds did not occur in the 2005 biennium as assumed in the previous projection, and the DOR believes they may be issued in fiscal year 2006. Before the refund adjustment, collections from corporation license tax are expected to increase 1.6 percent over actual fiscal year 2005 collections of $98.2 million. Collections for fiscal year 2007 are then expected to decrease by 2.5 percent.

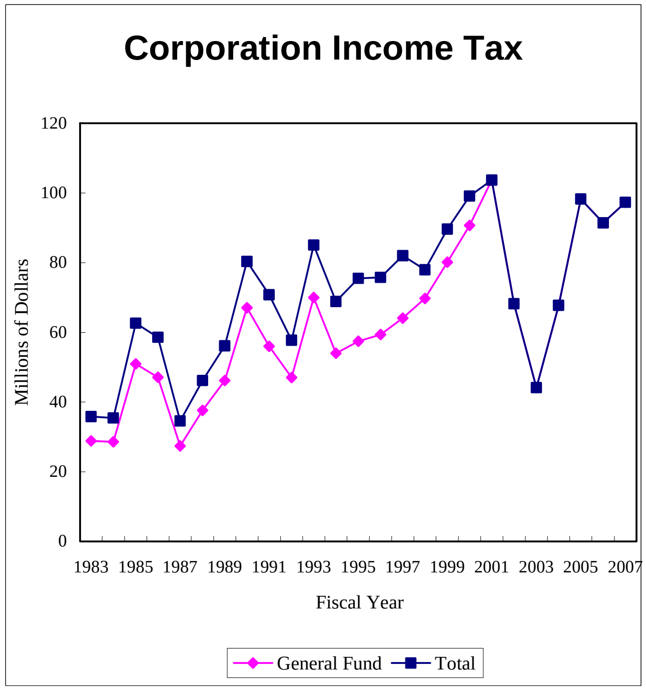
The DOR provides the estimates for corporation license tax audit collections. The recommendation for the 2007 biennium is $7.0 million, $3.5 million each fiscal year. In the 2005 biennium, actual audit collections, consisting of audit payments and interest and penalty payments, equaled $28.8 million ($14.2 million in fiscal 2004 and $10.6 million in fiscal 2005). The DOR estimates were used to create the recommendation, however the estimates are significantly understated when considering past collections. Additionally, the high audit collections in the 2005 biennium combined with the conservative estimates, distort the projected trend and make total growth appear lower than actually anticipated.



U.S. pre-tax corporation profits, as provided in the November 2005 Global Insight publication, are used in the development of the corporation license tax estimate. Consequently, the trend associated with the corporation license tax estimate is similar to the trend presented in the pre-tax profits series. As seen in the figure to the right, profits increased by almost 35.0 percent in calendar year 2005. In calendar year 2006 and 2007, growth slows significantly to 5.4 percent and negative 1.0 percent respectively.

Revenue Projection:

	Fiscal Year	Total Collections Millions	General Fund Collections Millions	GF Percent Change
A	1983	35.830832	28.832742	Not App.
A	1984	35.396240	28.573417	-0.90%
A	1985	62.609205	50.976990	78.41%
A	1986	58.584784	47.121070	-7.56%
A	1987	34.566361	27.371125	-41.91%
A	1988	46.200104	37.584806	37.32%
A	1989	56.139749	46.152627	22.80%
A	1990	80.315504	67.087905	45.36%
A	1991	70.784279	56.006784	-16.52%
A	1992	57.682672	47.027797	-16.03%
A	1993	85.054483	70.003987	48.86%
A	1994	68.871909	53.996713	-22.87%
A	1995	75.519940	57.425136	6.35%
A	1996	75.761891	59.336677	3.33%
A	1997	81.999138	64.078549	7.99%
A	1998	77.928498	69.724680	8.81%
A	1999	89.624560	80.142416	14.94%
A	2000	99.088867	90.682672	13.15%
A	2001	103.670487	103.670487	14.32%
A	2002	68.173253	68.173253	-34.24%
A	2003	44.137518	44.137518	-35.26%
A	2004	67.722940	67.722940	53.44%
A	2005	98.213717	98.213717	45.02%
F	2006	91.427000	91.427000	-6.91%
F	2007	97.281000	97.281000	6.40%



HJR2 Comparison:

Revised HJR 2 General Fund Revenue Estimates (In Millions)										
	Actual	HJR 2			RTIC Recommendations			Difference		
Revenue Source	Fiscal 2005	Fiscal 2006	Fiscal 2007	Biennium	Fiscal 2006	Fiscal 2007	Biennium	Fiscal 2006	Fiscal 2007	Biennium
Corporation Tax	$98.214	$81.148	$78.997	$160.145	$91.427	$97.281	$188.708	$10.279	$18.284	$28.563

INDIVIDUAL INCOME TAX

Revenue Description:

The tax is levied against taxable income, which is defined as Montana personal income adjusted for exemptions and deductions. Once tax liability is determined, the amount of tax due is computed by subtracting allowable credits.

Applicable Tax Rate(s):

Tax rates vary from 1.0% to 6.9%, depending on the level of taxable income. Tax brackets, personal exemption amounts, and the standard deduction are adjusted by the rate of inflation in each year. SB 407, enacted by the 2003 legislature, created a new capital gains income tax credit. As a result, the tax rate on capital gains income is less than the tax rate on ordinary income by 1 percent in tax years 2005 and 2006, and by 2 percent in tax year 2007 and beyond.

Distribution:

Prior to the enactment of SB 442 by the 2005 legislation, beginning fiscal 2004 through fiscal 2011, the Department of Revenue could distribute up to 0.45% of this general fund revenue source as an administrative assessment to a state special revenue account to pay debt service on the loan used to fund a POINTS replacement computer system (enacted in Senate Bill 271 by the 2003 legislature). SB 442 eliminated this provision. All proceeds are deposited into the general fund.

Collection Frequency:

Withholding taxes are collected monthly, bi-weekly, and weekly, and estimated taxes are collected quarterly.

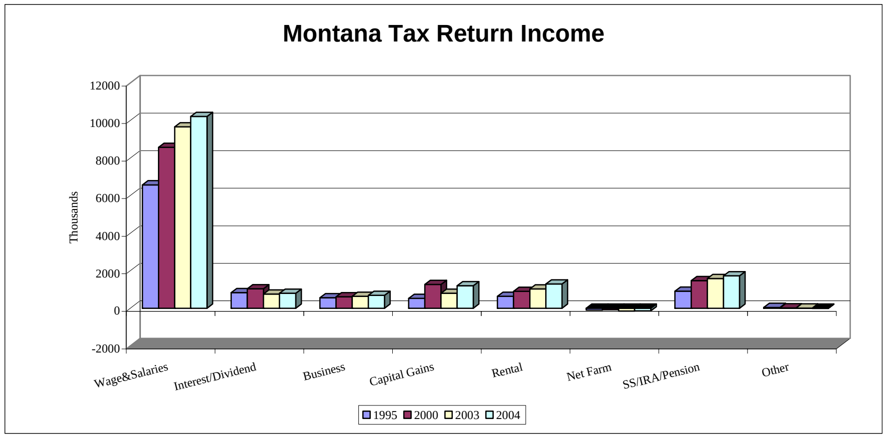
Statutory Reference:

Tax Rate (MCA) – 15-30-103
Tax Distribution (MCA) – 15-1-501(1)
Date Due – 15th day of the fourth month of the filer's fiscal year (15-30-144). Withholding taxes due monthly, quarterly, or on an accelerated schedule depending on income (15-30-204). Estimated taxes due on the 15th day of the 4th, 6th, and 9th month and the month following the close of the tax year.

Additional Information Since Adjournment:

The recommendation for individual income taxes is an increase of $153.2 million, or 12.4 percent, over the HJR 2 estimates for the 2007 biennium. Unexpectedly high collections in fiscal year 2005, an additional year of tax return data, coupled with new data from the Global Insight forecasting service were used to develop the recommendation for an upward adjustment to the individual income tax projection. Recommendations for the biennium include $677.8 million in fiscal 2006 and $712.6 in fiscal 2007.

Return data for the 2004 tax year became available in November. The figure to the right depicts the income category results of this data and compares it to data from tax years 1999, 2000, and 2003. As seen in this figure, most income sources experienced growth over tax year 2003. While growth in wages and salaries was expected, growth in dividends, capital gains, and rents and royalties was greater than anticipated.

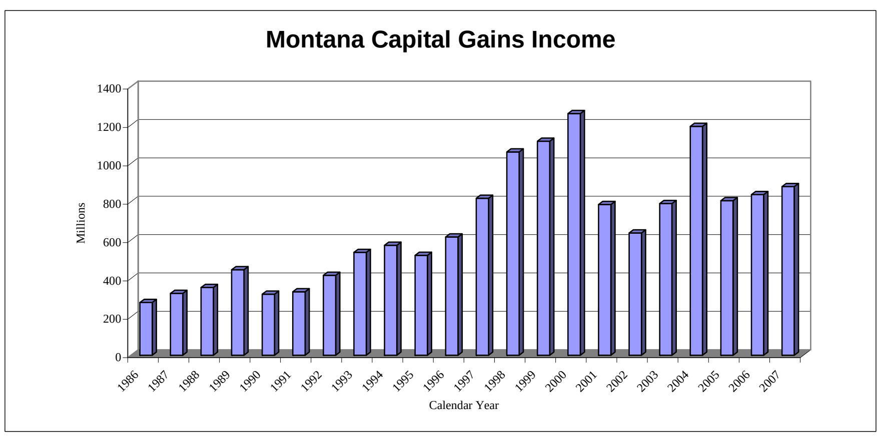


New information was used in the development of the individual income tax recommendations. Several modifications were made to the assumptions used in HJR 2. The economic assumptions used to produce the recommendation include:

1. Wage and salary income: increased by 5.8 percent in tax year 2004. HJR 2 assumed growth of 4.5 percent in tax years 2005 through 2007. While the assumption for 2004 was accurate, information provided by Global Insight shows wages and salaries growing at a rate of 8.4 percent in tax year 2005, 5.7 percent in tax year 2006, and 4.8 percent in tax year 2007.

2. Dividend income: increased by 27.6 percent in tax year 2004. Growth for tax year 2004 was estimated to be 12.0 percent. The assumption is that growth in this income source is the result of federal tax changes that reduced the tax on dividend income to 15.0 percent through tax year 2009. While a similar spurt of growth is not anticipated in future years, increased dividend income is expected during the period of preferential tax treatment. As a result, HJR 2 growth rates were not changed, but they are applied to the higher base of tax year 2004.

3. Capital gains income: increased by 50.9 percent in tax year 2004. As apparent in the figure to the right, income from capital gains nears the magnitude seen in the late 1990's. No growth had been assumed in tax year 2004 in HJR 2. Capital gains income includes the gains incurred from the sales of many forms of capital including land and equity investments. The tax return data provided by the DOR is provided in aggregate by taxpayer and does not segregate the sources of the gains. Regardless, it is assumed the significant increase of capital gains in



the 2004 tax year results from individuals who have taken advantage of the new federal preferential tax treatment. Such significant increases are not expected to continue in future tax years. As a result, the recommendation uses the 2004 tax year as a base and assumes a return to the long-term trend line into the future.

4. Rents and royalty income: increased by 25.8 percent in tax year 2004. The growth assumption for this source of income was 10.2 percent for the 2004 tax year. As in the case of capital gains data, this category includes three sources of income: rents, partnership, and royalty income. The income data is provided as an aggregate figure. There is no method for determining whether rental, partnership, or royalty income is responsible for the significant increase. However, the dramatic increase in oil and natural gas production in the state suggests that the increase can be attributed to royalty income. As long as oil and gas production remain at current levels, the assumption is that rent and royalties income will also be strong. Accordingly, HJR 2 growth rates were not changed but they are applied to the higher base of tax year 2004.

In addition to modifying these growth rates, the recommendation includes changes to the population adjustment factor and the non-resident filers multiplier. These factors were adjusted slightly to agree with new data provided through Global Insight.

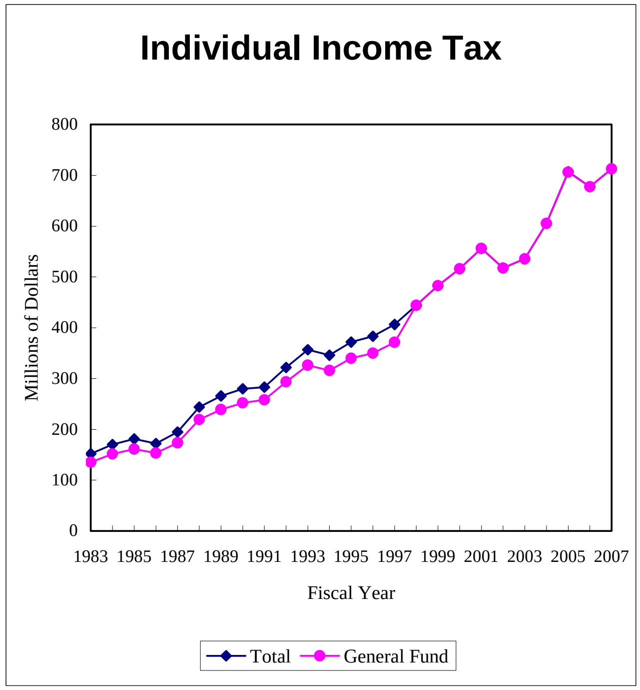
The DOR provides the estimates for individual income tax audit collections. The recommendation for the 2007 biennium is $45.0 million. In the 2005 biennium, actual audit collections, consisting of audit payments and interest and penalty payments, equaled $67.1 million ($29.9 million in fiscal 2004 and $37.2 million in fiscal 2005). The DOR estimates were used to create the recommendation, however the estimates are significantly understated when considering past collections. Additionally, the high audit collections in the 2005 biennium combined with the conservative estimates, distort the projected trend and make total growth appear lower than actually anticipated.

Estimated refunds for the 2005 tax year are expected to be higher than assumed in HJR 2 as a result of two factors related to the enactment of SB 407. The legislation became effective at the beginning of the 2005 tax year. In aggregate, this legislation was expected to reduce individual income tax collections in fiscal 2005 and subsequent years. First, the DOR distributed new withholding tables to the employers at the beginning of the 2005 tax year, followed by a revised tax table at a later date. There is still uncertainty when the new withholding tables, were implemented by employers in tax year 2005. Consequently, failure to use the new tables may result in additional refunds in fiscal 2006. Next, discussions with accounting firms indicate that some taxpayers were advised to make estimated payments, unadjusted for the impact of SB 407. Such actions would mean that taxpayers were paying taxes at too high a rate. This action would also result in additional refunds in fiscal 2006. The refund impacts of both situations is included in the recommendation.

Collectively, these changes produce a recommendation of $677.8 million in fiscal year 2006. This is an increase of 11.6 percent from the HJR 2 estimate. In fiscal year 2007, the recommendation is $712.6 million. The estimate is 13.1 percent greater than the HJR 2 estimate.

Revenue Projection:

	Fiscal Year	Total Collections Millions	General Fund Collections Millions	GF Percent Change
A	1983	151.800311	135.102282	Not App.
A	1984	170.346345	151.608247	12.22%
A	1985	181.057157	161.140870	6.29%
A	1986	172.216130	153.272356	-4.88%
A	1987	194.676947	173.262483	13.04%
A	1988	243.768721	219.241292	26.54%
A	1989	265.539814	238.963596	9.00%
A	1990	279.642960	252.230465	5.55%
A	1991	282.960086	258.216424	2.37%
A	1992	321.538093	293.564151	13.69%
A	1993	356.986934	326.187735	11.11%
A	1994	345.643403	315.677433	-3.22%
A	1995	371.902909	339.939156	7.69%
A	1996	383.091612	350.161013	3.01%
A	1997	406.275740	371.275410	6.03%
A	1998	444.160729	444.160729	19.63%
A	1999	483.031571	483.031571	8.75%
A	2000	516.261912	516.261912	6.88%
A	2001	556.014554	556.014554	7.70%
A	2002	517.567691	517.567691	-6.91%
A	2003	535.830664	535.830664	3.53%
A	2004	605.582309	605.348420	12.97%
A	2005	707.343334	706.234580	16.67%
F	2006	677.815000	677.815000	-4.02%
F	2007	712.611000	712.611000	5.13%



HJR2 Comparison:

Revised HJR 2 General Fund Revenue Estimates (In Millions)										
	Actual	HJR 2			RTIC Recommendations			Difference		
Revenue Source	Fiscal 2005	Fiscal 2006	Fiscal 2007	Biennium	Fiscal 2006	Fiscal 2007	Biennium	Fiscal 2006	Fiscal 2007	Biennium
Individual Income Tax	$706.235	$607.178	$630.060	$1,237.238	$677.815	$712.611	$1,390.426	$70.637	$82.551	$153.188

OIL AND NATURAL GAS PRODUCTION TAX

Revenue Description:

The oil and natural gas production tax is imposed on the production of petroleum and natural gas in the state. Gross taxable value of oil and natural gas production is based on the type of well and type of production.

Applicable Tax Rate(s):

The oil and natural gas production tax has numerous tax rates depending on several factors. These factors include whether the oil or gas is produced from a stripper well, a stripper incentive well, from a well initially drilled before 1999 or after, from a well newly drilled within the last year or 18 months, and whether the interest being taxed is the working interest or the royalty interest. The Board of Oil and Gas Conservation imposes an additional privilege and license (P & L) tax on all oil and natural gas tax rates. For the 2007 biennium, the P&L tax rate is 0.26 percent. HB 758 (enacted by the 2005 legislature) allows an additional tax rate of 0.04 percent to generate revenue for local impacts for local governments. The two taxes may not exceed 0.3 percent. HB 535 (enacted by the 2005 legislature) created out of the "stripper well exemption" category a new tax category called "stripper well bonus" which is defined as production from a stripper well that produces three barrels a day or less. The figure to the right shows tax rate percentages for each type of pre-1999 oil and post-1999 oil, <u>excluding</u> the P & L tax and the new Local Impact tax. The quarterly tax rates on stripper production and on incremental production are lower than that for regular production unless the price of West Texas Intermediate averages above $30 for the quarter. Similarly, the quarterly tax rate for stripper well exemption production (1-3 barrels a day) is lower than that for regular production unless the price of West Texas Intermediate averages above $38 for the quarter.

Oil and Natural Gas Production Tax Rates *

Oil Production	Tax Rates
<u>Working Interests</u>	
Pre 99 after 12 Months (Regular)	12.50%
Post 99 First 12 Months (New)	0.50%
Post 99 after 12 months (Regular)	9.00%
Stripper 4-10 barrels per day	5.50%
Stripper 11-15 barrels per day	9.00%
Stripper Well Exemption (1-3 barrels per day)	0.50%
Pre99 Horizontal after 18 months	12.50%
Post 99 Horizontal first 18 months	0.50%
Post 99 Horizontal after 18 months	9.00%
Incremental - secondary	8.50%
Incremental - tertiary	5.80%
Pre99 Horizontal Recomp - after 18 months	12.50%
Post99 Horizontal Recomp - first 18 months	5.50%
Post99 Horizontal Recomp - after 18 months	9.00%
<u>Royalty Interests</u>	14.80%
Natural Gas Production	
<u>Working Interests</u>	
Pre-99 after 12 months	14.80%
Post 99 first 12 months	0.50%
Post 99 after 12 months	9.00%
Pre 99 stripper wells	11.00%
Horizontal first 18 months	0.50%
Horizontal after 18 months	9.00%
<u>Royalty Interests</u>	14.80%

If the West Texas price of oil exceeds $30/bbl in a quarter, the rates for stripper

* Excluding the P & L and Local Impact tax rates

Distribution:

Once the oil and natural gas production taxes have been collected, the revenue is first distributed based on the amounts collected from the P & L and Local Impact taxes. The amounts from the P & L tax are distributed to the: 1) Board of Oil and Gas Conservation; and 2) the Legislative Services Division - $50,000 only in the 2007 biennium. The amounts from the Local Impact tax are distributed to the oil, gas, and coal natural resource state special revenue account. The amounts received by the Board and the oil, gas, and coal natural resource account vary based on a sliding scale based on the P & L tax set by the Board. Counties producing oil receive the next share of the total revenue with each county having its own distribution percentage of total revenue, including the revenue generated by the P & L and Local Impact taxes. The remainder of the revenue is distributed to other state accounts in the following manner:

Fiscal 2004 though Fiscal 2011

- Coal bed methane account – 1.23%
- Reclamation and development account – 2.95%
- Orphan share account – 2.95%
- University system 6 mill levy account – 2.65%
- General fund – the remainder (90.22%)

The distributions of county shares and the amount of oil and natural gas production tax revenue deposited in the oil, gas, and coal natural resource account are statutorily appropriated and are based on the statutorily set percentages for each county.

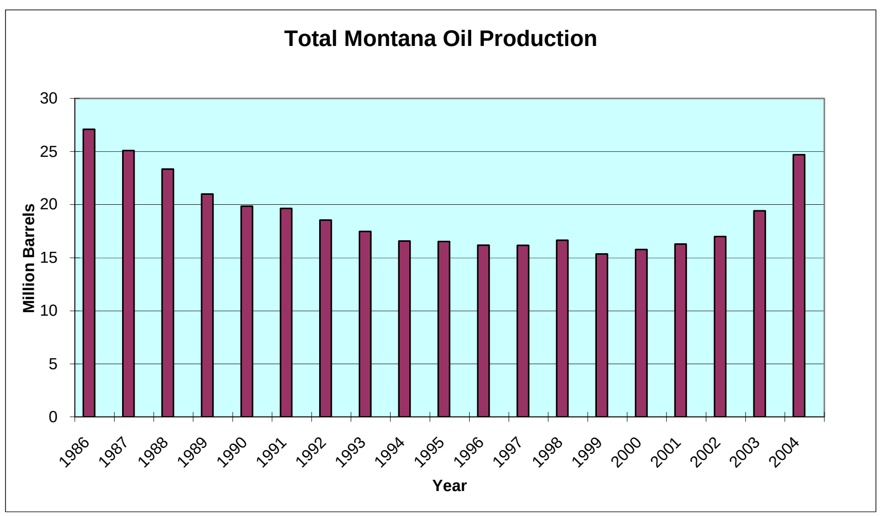
Collection Frequency:

Quarterly: The oil and natural gas production tax is due 60 days after the end of the production quarter.

Statutory Reference:

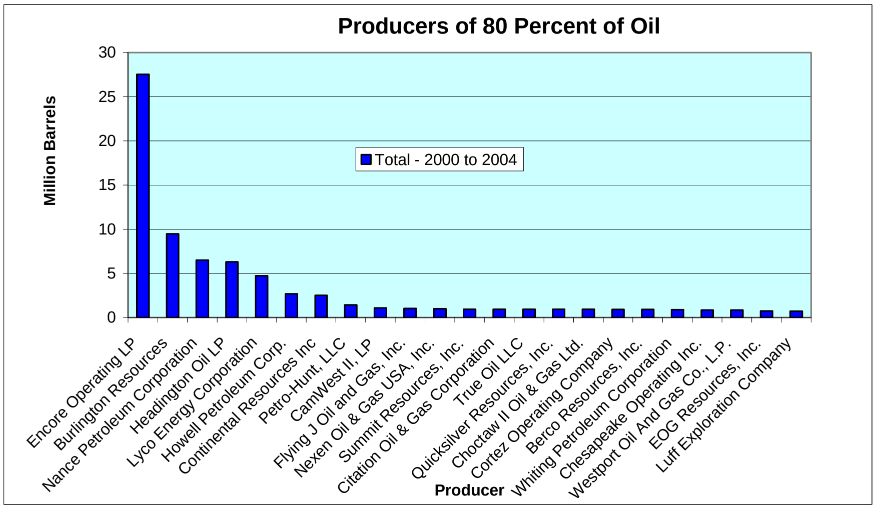
Tax Rate (MCA) – 15-36-30. Privilege and license tax – 82-11-131, Administrative Rules 36.72.1242
Tax Distribution (MCA)– 15-36-331(4), 15-36-332(2&3) (to taxing units)
Date Due – within 60 days after the end of the calendar quarter (15-36-311(1))

Additional Information Since Adjournment:



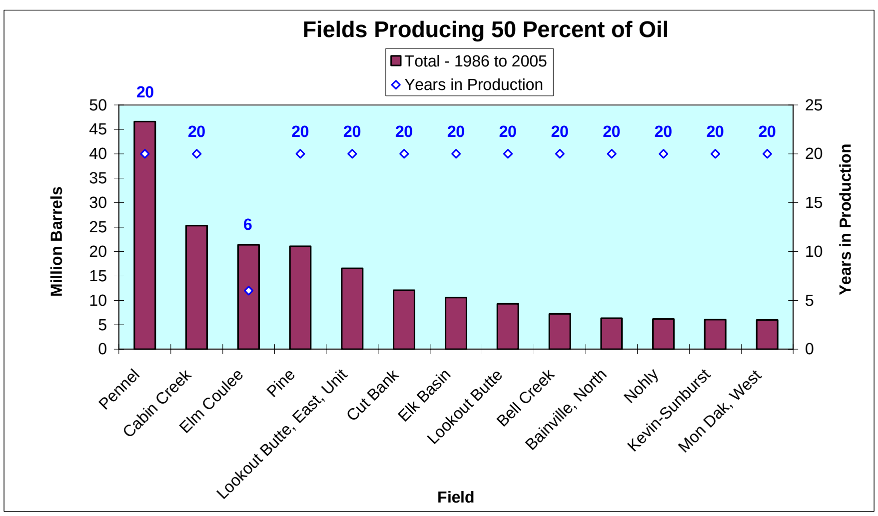
The recommendations for the oil and natural gas estimates are for an increase of $38.2 million in fiscal 2006 and $27.6 million in fiscal 2007 for a total of $65.8 million above HJR 2 estimates for the 2007 biennium. The oil estimates were based on assumptions of 34.9 million barrels at $57.79/per barrel in fiscal 2006, and 35.5 million barrels at $50.49/per barrel in fiscal 2007. The natural gas estimates were based on assumptions of 102.2 million MCF at $8.35/per MCF in fiscal 2006, and 101.1 million MCF at $8.10/per MCF in fiscal 2007.

The oil industry in Montana has been undergoing major changes. Improved techniques have allowed new fields to be developed and old fields to be more productive. The figures on this page show various aspects of this industry.



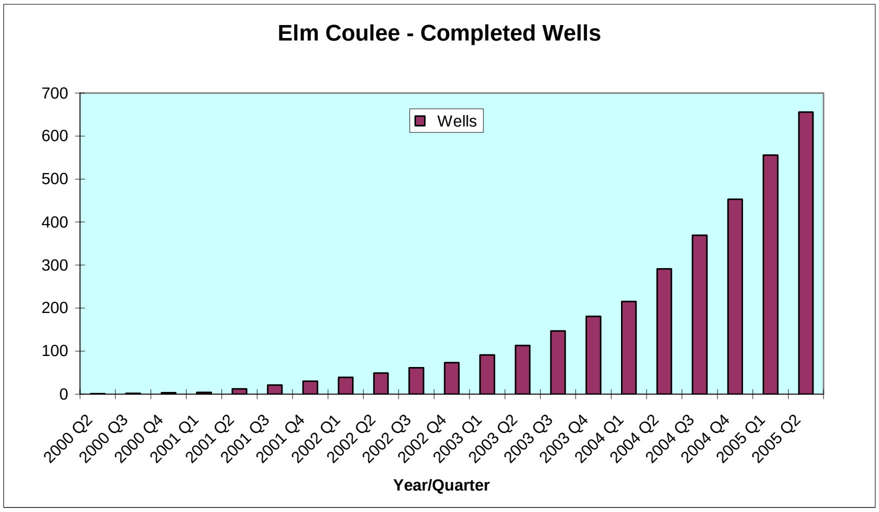
Data from the Board of Oil and Gas Conservation enabled an isolation of production for each field. Analysis of the field data indicated that the majority of increased production is from the relatively new Elm Coulee field in Richland County. Production from fields other than Elm Coulee grew an average of 2.2 percent for the past five years, indicating that most of the increase in production is from the Elm Coulee field. Industry personnel state that although this field has yet to be fully defined, it probably is nearing that stage. When this occurs, fewer new wells will be spudded (drilling initiated).

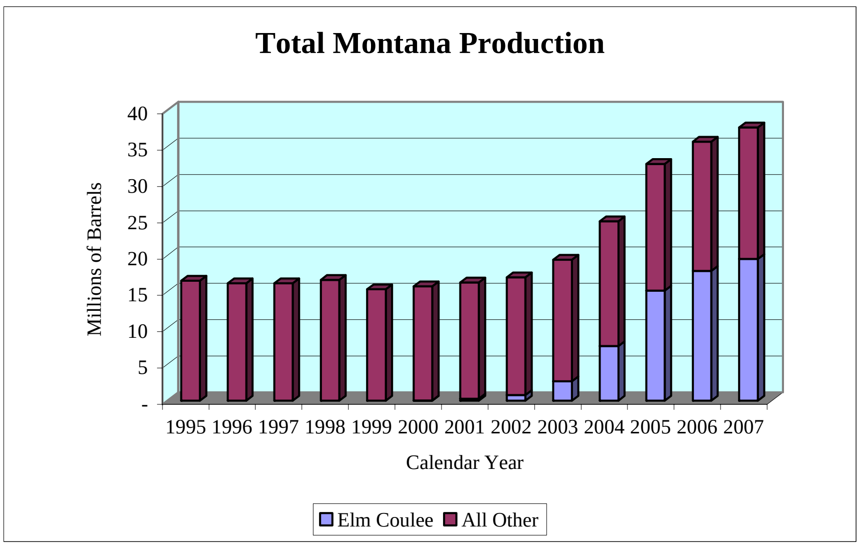
Existing wells will then follow a production decline curve unique to the characteristics of the field. Fields tapped through horizontal drilling, such as Elm Coulee, tend to be depleted more rapidly than those tapped vertically. The importance of Elm Coulee is shown in the figure below. The figure shows that even though the field has been in production for only six of the last 20 years, it ranks third in total production out of the major fields that have been producing for the entire 20 years. The Elm Coulee field first began production in 2000. From that time through August 2005, 197 wells had been completed and 48 wells have been spudded. Future production from completed wells can be estimated by developing a normalized production decline curve from the producing wells.



In doing so, the difficulty of having different starting time for each well can be eliminated by averaging each well's production from a common time point. The result is a curve that represents the average production of wells in the Elm Coulee field by month of production. Knowing monthly production from each well and the date it was placed into production are essential for estimating oil tax revenue because tax rates vary based on the length of time a well has been in production.

Production from future wells can be estimated by applying the production curve coefficients to an estimate of future spudded wells. The figure below shows the history of completed wells since the beginning of this field.



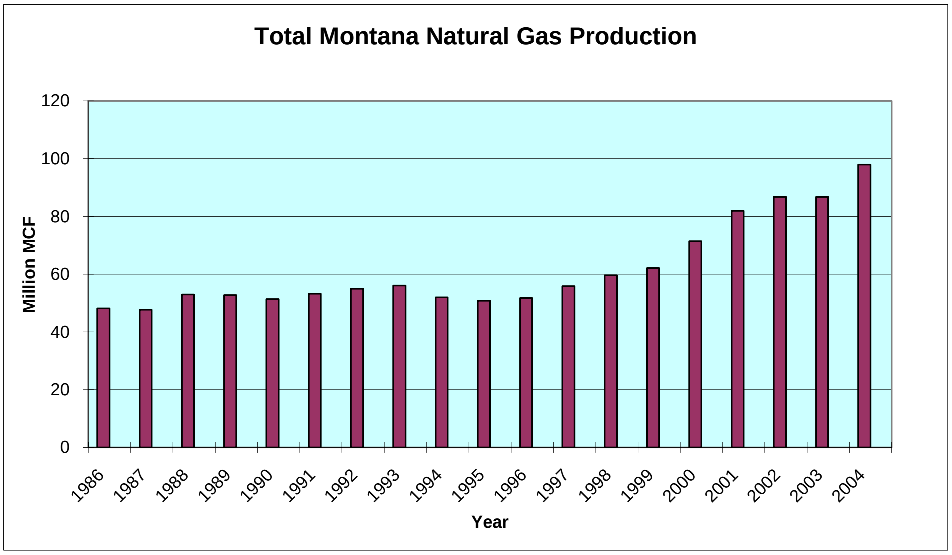


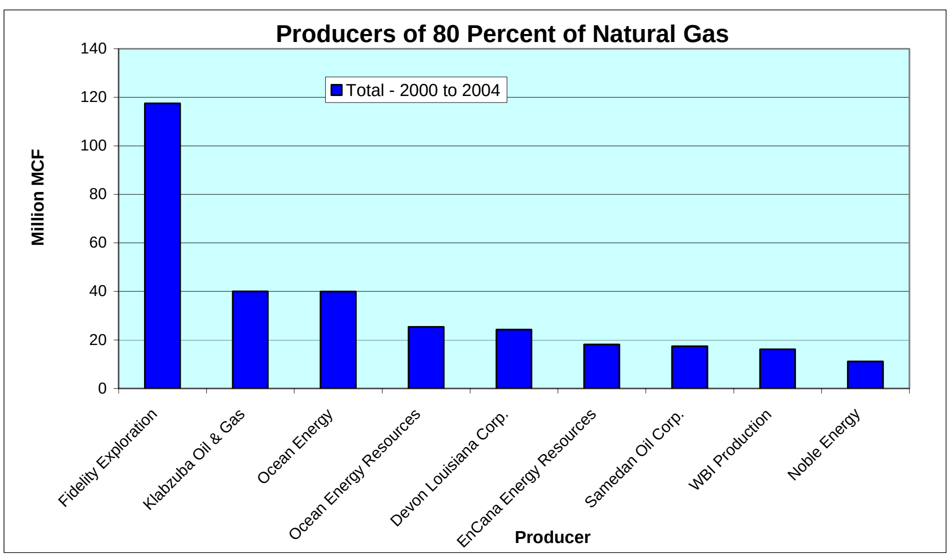
The importance this one field plays in the oil production tax estimate for the 2007 biennium is seen in the figure above. For this biennium it is estimated that, 51 percent of total statewide production comes from Elm Coulee.

In determining a price estimate for oil, Global Insight's future forecasts of West Texas Intermediate crude were used. In general, the price of WTI oil is expected to decrease from $63/barrel to $50/barrel during the 2007 biennium. Because the price received from Montana oil is normally lower than the quoted price for WTI, an adjustment to the WTI price was applied based on historical comparisons between the two prices.

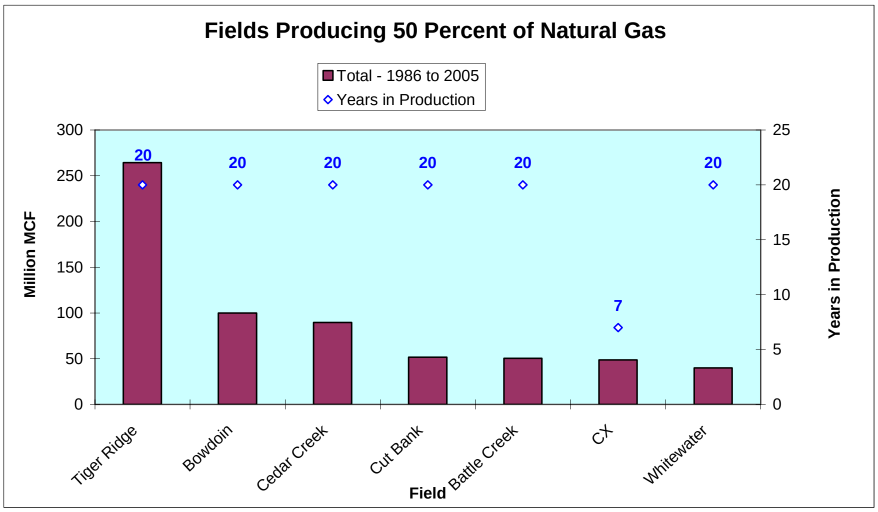
Natural Gas

The natural gas industry in Montana has also been undergoing major changes. Improved techniques have allowed new fields to be developed and old fields to be more productive. The figures on this page show various aspects of this industry. Data from the Board of Oil and Gas Conservation indicate that the majority of increased production is from the relatively new CX field in Big Horn County and the Elm Coulee field in Richland County. Other fields that exhibit increasing production are the Bowdoin and Cedar Creek fields, the second and third largest producing fields, respectively.





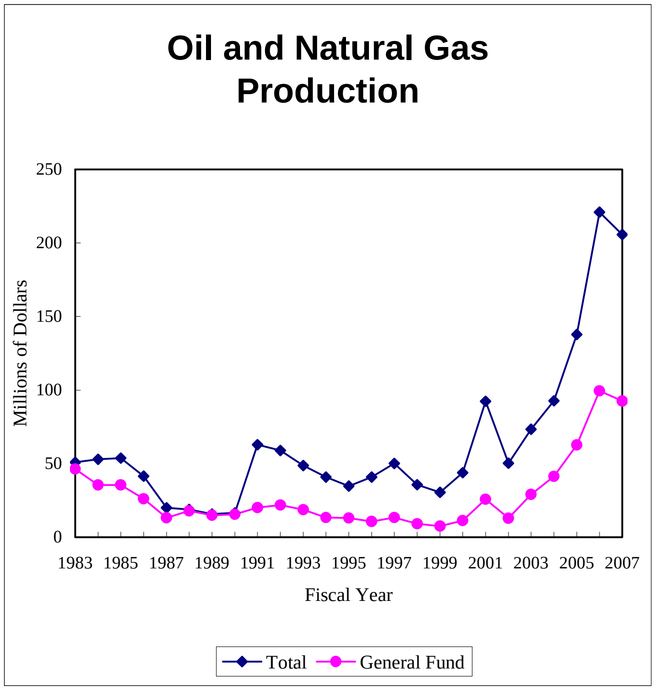
Since its peak production in 1999, production from Tiger Ridge, the largest producing field, has declined. By excluding production from fields with increasing production, it was found that production from the remaining fields has been decreasing since 2001. Of the fields with increasing production, most is coming from the CX and Elm Coulee fields. The importance of the CX field is shown in the figure below. The figure shows that even though the CX field has been in production for only seven of the last 20 years, in ranks sixth in total production out of the major fields that have been producing for the entire 20 years. A similar analysis to that used for oil can also be used for natural gas. The CX field began production in April 1999 and in 2004 produced 12.3 million MCF. From that time through August 2005, 543 wells have been completed, 95 of which were completed in 2005. In 2005, 25 wells have been spudded. The Elm Coulee field began production in 2000 and in 2004 produced 5.7 million MCF. As with oil, the development of a normalized production curve from individual wells eliminates the difficulty of having different starting time for each well by averaging each well's production from a common point in time. The result is a curve that represents the average production of wells in the CX field by month of production.



Global Insight does not provide future estimates of natural gas prices. In determining a price estimate for natural gas, Henry Hub spot market future forecasts were used. In general, the price is expected to decrease to $9.19/MCF at the end of the 2007 biennium. Because the price received from Montana natural gas is normally lower than the national price for natural gas, an adjustment was applied based on historical comparisons between the two prices.

Revenue Projection:

	Fiscal Year	Total Collections Millions	General Fund Collections Millions	GF Percent Change
A	1983	50.873263	46.313019	Not App.
A	1984	52.977130	35.484010	-23.38%
A	1985	53.667357	35.472434	-0.03%
A	1986	41.441086	26.043170	-26.58%
A	1987	19.904239	13.254877	-49.10%
A	1988	18.913097	17.975582	35.61%
A	1989	15.748241	14.959251	-16.78%
A	1990	16.486405	15.567426	4.07%
A	1991	62.879742	20.163269	29.52%
A	1992	58.892324	21.822893	8.23%
A	1993	48.650604	18.676586	-14.42%
A	1994	40.871318	13.403408	-28.23%
A	1995	34.704332	12.963887	-3.28%
A	1996	40.826475	10.665986	-17.73%
A	1997	50.150068	13.283093	24.54%
A	1998	35.709042	9.120152	-31.34%
A	1999	30.446634	7.505617	-17.70%
A	2000	43.772950	11.362741	51.39%
A	2001	92.395790	25.791723	126.99%
A	2002	50.303610	12.902439	-49.97%
A	2003	73.389376	29.086038	125.43%
A	2004	92.676048	41.323718	42.07%
A	2005	137.754330	62.625939	51.55%
F	2006	220.851727	99.410000	58.74%
F	2007	205.620267	92.554000	-6.90%



HJR2 Comparison:

Revised HJR 2 General Fund Revenue Estimates (In Millions)										
	Actual	HJR 2			RTIC Recommendations			Difference		
Revenue Source	Fiscal 2005	Fiscal 2006	Fiscal 2007	Biennium	Fiscal 2006	Fiscal 2007	Biennium	Fiscal 2006	Fiscal 2007	Biennium
Oil Severance Tax	$62.626	$61.192	$64.958	$126.150	$99.410	$92.554	$191.964	$38.218	$27.596	$65.814

PROPERTY TAX

Revenue Description:

Montana law requires counties to levy a county equalization levy of 55 mills, a state equalization levy of 40 mills and 6 mills for the university system against all taxable value in each county. A mill levy of 1.5 mills is also applied against all property in the five counties with a vo-tech college. Taxable value is defined as the market value of statutorily defined property times a statutory tax rate. Property valued at market value includes personal property, utility property, railroad and airline property, and mineral net and gross proceeds. The assessed value of residential and commercial real estate is the market value phased in over the reappraisal cycle. Agricultural land and timberland are valued on a productivity basis and their values are also phased in over the reappraisal cycle. Beginning January 1, 2003, livestock is no longer taxed.

Beginning January 1, 2003, residential and commercial property as well as agricultural land and timberland reflect the impact of a new reappraisal on market values. The current reappraisal cycle is 6 years, during which increases in property values will be phased in by 1/6th per year. Property that declines in value will be assessed immediately at its new reappraised value. The impact of reappraisal on assessed values increased the market value of the average residence by 20.2 percent. The equivalent increases for commercial property were 18.5 percent and for agricultural land by 15.3 percent.

The 2003 legislature passed a reappraisal mitigation bill - SB 461 (see below). Beginning in tax year 2003, reappraisal values were phased in over the next six years. The new tax rates and the new homestead and comstead exemptions are shown in the accompanying table:

In addition to the tax on property, this revenue component includes collections from "non-levy" sources that are distributed on the basis of mills levied by taxing jurisdictions. These non-levy sources include the state share of coal gross proceeds taxes, federal forest revenues, and other smaller revenue sources.

SB 461 Tax Rates and Exemption Percentages for Class 4 Residential and Commercial Property

Fiscal Year	Tax Rate	Class 4 Residential Exemption	Class 3 Multi Family Housing Exemption	Class 4 Commercial Exemption
2003 (prior law)	3.46%	31.0%	31.0%	13.0%
2004	3.40%	31.0%	31.0%	13.0%
2005	3.30%	31.4%	31.4%	13.3%
2006	3.22%	32.0%	32.0%	13.8%
2007	3.14%	32.6%	32.6%	14.2%
2008	3.07%	33.2%	33.2%	14.6%
2009	3.01%	34.0%	34.0%	15.0%

This source also includes the state's share of protested taxes paid by centrally assessed companies. Should the state fail in it defense of the taxation of these companies, the protested taxes must be returned to the taxpayer. With the enactment of Senate Bill 87 by the 2005 legislature, one-half of protested taxes from the states 95 mills is deposited to the general fund and one-half is deposited to a fiduciary fund.

Applicable Tax Rate(s):

Each property class has its own tax rate that is applied to assessed value to produce a taxable value. For every $1,000 in taxable value, each mills generates $1 in state property taxes.

Distribution:

Most property tax receipts are deposited into the general fund. There are two exceptions: 1) revenue associated with the 6-mill university levy is deposited to the state special revenue fund; and 2) half of the revenue paid under protest for centrally assessed property is deposited in a fiduciary fund.

Collection Frequency:

Monthly with significant state deposits in December and June.

Statutory Reference:

Tax Rate (MCA) – 20-9-331(1), 20-9-333(1)
Tax Distribution (MCA) - 20-9-331(1), 20-9-333(1)
Date Due – one-half of taxes due November 30th and one-half due May 31st (15-16-102(1)), county treasurers must remit to the Department of Revenue within the first 20 days of each month money received in the previous month (15-1-504(1))

Additional Information Since Adjournment:

Property tax revenue for the 2007 biennium is recommended to increase by $5.4 million or 1.5 percent over the HJR 2 revenue estimate. Since the last legislative session, taxable values for tax year 2005 (fiscal 2006) have become known and can be used to recalculate estimated property taxes for the biennium (see the table below).

Property Taxable Values

Tax Class	Name	TY 2005	FY 2006	FY 2007
Class 1	Net Proceeds	$2,694,216	$2,694,216	$2,694,216
Class 2	Gross Proceeds	13,045,195	13,045,195	13,045,195
Class 3	Ag Land	140,988,242	140,988,242	140,847,254
Class 4	Real Property	1,129,794,467	1,129,794,467	1,174,986,246
Class 5	Co-ops	34,611,220	34,611,220	34,611,220
Class 7	Independent Telephone	953,438	953,438	953,438
Class 8	Personal Property	123,054,946	124,972,142	130,096,000
Class 9	Utilities	238,766,675	238,766,675	238,527,908
Class 10	Timber Land	6,793,765	6,793,765	6,793,762
Class 12	RR & Airlines	44,267,220	44,267,220	43,580,253
Class 13	Electric, TelCom	122,845,989	122,845,989	122,845,989
Class 14	Wind Generation	0	0	6,412,500
Total		$1,857,815,373	$1,859,732,569	$1,915,393,981

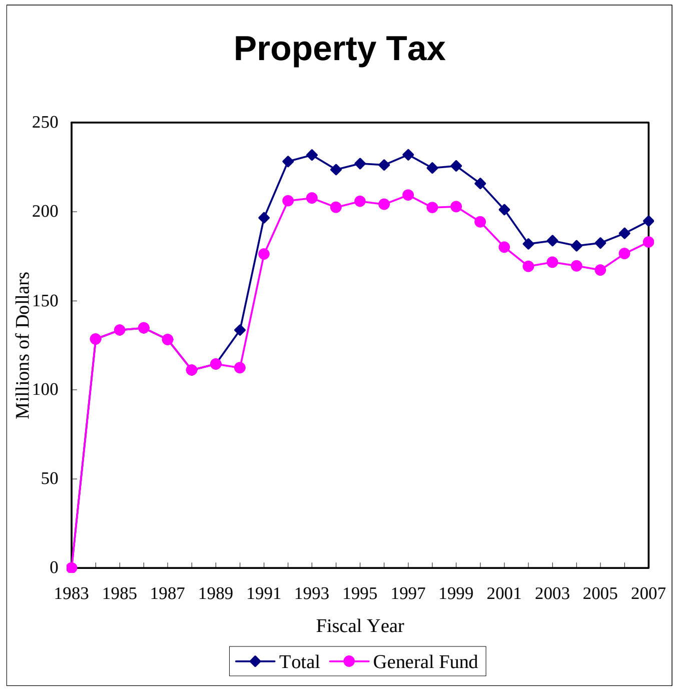
There are three notable changes to the property tax revenue estimate:

1. Actual tax year 2005 (fiscal 2006) statewide taxable value increased over the prior year by 4.4 percent, whereas the HJR2 revenue estimate projected a 2.5 percent increase.
2. The growth changes in tax year 2005 and new information warrant adjusting the estimated tax year 2006 (fiscal 2007) growth rates for class 8, business equipment from 2.9 percent to 4.1 percent; and class 13, telecommunication and electric generation property from -1.6 percent growth to 0 percent, or no change in taxable value.

3. Protested property taxes (net of settled cases) are estimated to be $2.4 million higher each year of the biennium than the SB 87 estimate. Fifty percent of this amount is removed from the general fund, so this is an offset of $1.2 million a year.

Revenue Projection:

	Fiscal Year	Total Collections Millions	General Fund Collections Millions	GF Percent Change
A	1983	0.000000	0.000000	Not App.
A	1984	128.445172	128.445172	Not App.
A	1985	133.608178	133.608178	4.02%
A	1986	134.707251	134.707251	0.82%
A	1987	128.225413	128.225413	-4.81%
A	1988	111.111138	111.111138	-13.35%
A	1989	114.444609	114.444609	3.00%
A	1990	133.619694	112.374543	-1.81%
A	1991	196.551532	176.154583	56.76%
A	1992	228.220531	206.138029	17.02%
A	1993	231.757476	207.646372	0.73%
A	1994	223.577122	202.381945	-2.54%
A	1995	226.944990	205.842671	1.71%
A	1996	226.234755	204.082588	-0.86%
A	1997	231.943080	209.284365	2.55%
A	1998	224.562154	202.350380	-3.31%
A	1999	225.681256	202.774979	0.21%
A	2000	215.866432	194.196158	-4.23%
A	2001	201.103545	180.050247	-7.28%
A	2002	181.923409	169.339388	-5.95%
A	2003	183.690786	171.679862	1.38%
A	2004	180.905286	169.530994	-1.25%
A	2005	182.394383	167.270350	-1.33%
F	2006	187.902000	176.391000	5.45%
F	2007	194.733000	182.900000	3.69%



HJR2 Comparison:

Revised HJR 2 General Fund Revenue Estimates (In Millions)										
	Actual	HJR 2			RTIC Recommendations			Difference		
Revenue Source	Fiscal 2005	Fiscal 2006	Fiscal 2007	Biennium	Fiscal 2006	Fiscal 2007	Biennium	Fiscal 2006	Fiscal 2007	Biennium
Property Tax	$167.270	$173.804	$180.062	$353.866	$176.391	$182.900	$359.291	$2.587	$2.838	$5.425

COMMON SCHOOL INTEREST AND INCOME

Revenue Description:

Lands granted by the federal government to the state for the benefit of public schools generate income. The common school trust is actually part of the trust and legacy trust fund that includes nine other trusts. Prior to fiscal 1996, interest and income from the common school trust was deposited in the state equalization account. Beginning in fiscal 1996, this interest and income was deposited in the general fund, as mandated by SB 83, passed by the 1995 legislature. Beginning fiscal 2003, House Bill 7 from the August 2002 special legislative session changed the deposit to the state special revenue guarantee account and statutorily appropriated the money for schools. The estimates show the amount of revenue deposited to the guarantee account and are net of amounts diverted (of mineral royalties, timber sale revenue, and income) for DNRC administration costs. Included is timber revenue for school technology and the amounts of mineral royalty revenue that is required to pay interest and principal on the SB 495 loan. These items are explained below.

Common school lands produce two kinds of revenue: 1) distributable income such as interest earnings, agricultural rents or crop shares, and timber sale revenue; and 2) permanent income that is returned to the trust such as income from the sale of minerals (see the effects of Senate Bill 495 from the 2003 legislative session below), land, and easements. Excluding the amount of timber sale revenue diverted for DNRC administration and school technology and after a 3.0 percent deduction of the revenue for use by the Department of Natural Resources and Conservation (DNRC), 95 percent of distributable revenue is available to fund schools and, due to Senate Bill 48 (discussed below), the remaining 5.0 percent is available to fund the Trust Land Management Division of DNRC. The 3.0 percent allocation to DNRC is used for resource development purposes. Timber revenue is allocated: 1) first to DNRC to fund a portion of its timber program based on the amount appropriated by the legislature (the remaining portion is funded with timber sale revenue from the capital land grant and other land trusts that generate timber revenue); 2) the amount received from production over 18 million board feet is deposited into the state special revenue fund for school technology equipment and training and is statutorily appropriated to OPI (House Bill 41 enacted by the 2001 legislature and House Bill 7 from the August 2002 special legislative session); and 3) any remainder for the support of public schools.

Senate Bill 48, passed by the 1999 legislature, provides for the diversion of the following funds for the purpose of funding the Trust Land Management Division in the DNRC: 1) mineral royalties; 2) revenues from the sale of easements; and 3) 5.0 percent of interest and income previously credited to the common school trust. The amount of the money diverted from the common school trust reduces the growth of the trust fund balance and, hence, reduces the amount of distributable interest earnings.

As of October 1, 1995, all fixed-income investments held by the state's major trust funds (which include the trust and legacy fund of which the common school trust is a part), were transferred to a newly-created Trust Fund Bond Pool (TFBP). The majority of common school trust funds are invested as part of the TFBP. Some funds, however, are invested on a short-term basis in the state's Short Term Investment Pool (STIP). The state Constitution prohibits the investment of common school trust funds in common stock. Interest income is distributed 95 percent to the guarantee account and 5 percent is available for DNRC administration with the remainder deposited to the trust.

Senate Bill 495 (enacted by the 2001 legislature) authorized DNRC to purchase the mineral production rights (with a loan from the coal severance trust) from the common school trust. The department subsequently purchased $138.9 million of future mineral royalties (over an approximate 30-year period) from the school trust for $46.4 million. Since these royalties will no longer be deposited to the trust, interest earnings from the trust corpus are lessened. However, additional interest earnings are generated from the proceeds of the sale, but it is estimated that interest losses will exceed interest gains after fiscal 2012. It is estimated that the trust balance will be $94.7 million less after the 30-year period. For further information and analysis on Senate Bill 495 contact the Legislative Fiscal Division for a copy of the two-part report: "Senate Bill 495-Implementation, Impacts and Implications".

Applicable Tax Rate(s): N/A

Distribution:

As described above, interest and income from common school lands (including a portion of timber sales and after amounts diverted for DNRC administration) are distributed 95.0 percent to the state special revenue guarantee account and is statutorily appropriated for schools. The remaining 5.0 percent is available to fund the Trust Land Management Division with the remainder deposited to the trust fund. The amounts deposited to the guarantee account are shown in this revenue source.

Collection Frequency:

Revenue is received monthly, however, distribution to the state special revenue fund takes place three times per year.

Statutory Reference:

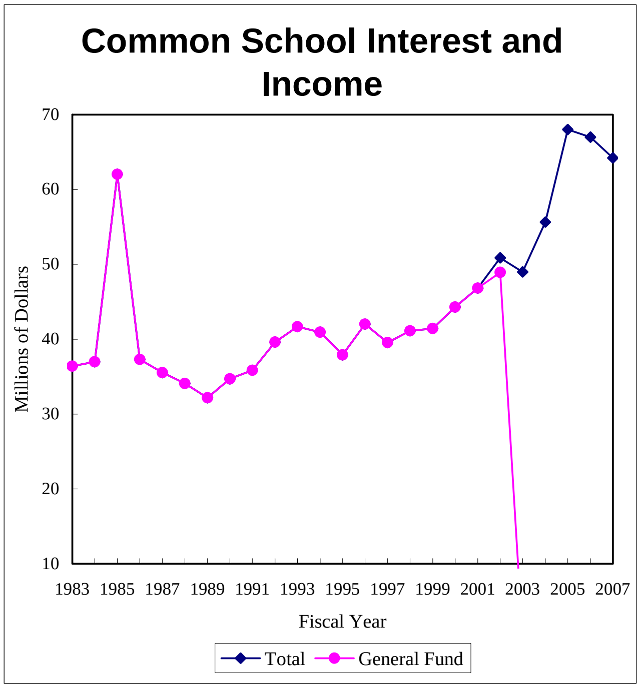
Tax Rate – NA
Distribution (MCA) – Montana Constitution Article X, Section 5; 20-9-342 (school technology); 20-9-622 (guarantee account)
Other (MCA) –DNRC trust land administration diversion (77-1-109)
DNRC timber sale program diversion (77-1-613)
DNRC land bank administration diversion (77-2-362)
DNRC resource development diversion (77-1-607)
Enabling Act, Section 10
Date Due - the last business day of February following the calendar year in which the money was received (20-9-342).

Additional Information Since Adjournment:

Although the committee directed staff to limit their review and potential adjustments to only income taxes, corporation income taxes, and oil and natural gas production taxes, it did request staff to calculate the associated impact on common school interest and income revenues if adjustments were adopted for oil and natural gas price and production levels.

Revenue Projection:

	Fiscal Year	Total Collections Millions	General Fund Collections Millions	GF Percent Change
A	1983	36.398297	36.398297	Not App.
A	1984	36.982835	36.982835	1.61%
A	1985	62.050661	62.050661	67.78%
A	1986	37.301053	37.301053	-39.89%
A	1987	35.529619	35.529619	-4.75%
A	1988	34.078544	34.078544	-4.08%
A	1989	32.165382	32.165382	-5.61%
A	1990	34.706901	34.706901	7.90%
A	1991	35.865505	35.865505	3.34%
A	1992	39.616168	39.616168	10.46%
A	1993	41.673746	41.673746	5.19%
A	1994	40.943551	40.943551	-1.75%
A	1995	37.904099	37.904099	-7.42%
A	1996	42.031801	42.031801	10.89%
A	1997	39.538792	39.538792	-5.93%
A	1998	41.129779	41.129779	4.02%
A	1999	41.432733	41.432733	0.74%
A	2000	44.296034	44.296034	6.91%
A	2001	46.845895	46.845895	5.76%
A	2002	50.875186	48.937673	4.47%
A	2003	48.977342	0.000000	-100.00%
A	2004	55.663022	0.000000	Not App.
A	2005	68.035764	0.000000	Not App.
F	2006	67.010000	0.000000	Not App.
F	2007	64.218000	0.000000	Not App.



HJR2 Comparison:

Revised HJR 2 Non-general Fund Revenue Estimates (In Millions)										
	Actual	HJR 2			RTIC Recommendations			Difference		
Revenue Source	Fiscal 2005	Fiscal 2006	Fiscal 2007	Biennium	Fiscal 2006	Fiscal 2007	Biennium	Fiscal 2006	Fiscal 2007	Biennium
Common School I & I	$68.036	$57.146	$56.233	$113.379	$67.013	$64.225	$131.238	$9.867	$7.992	$17.859

2007 BIENNIUM PROJECTION

The Figure at the right shows the projected general fund balance for the 2007 biennium. Amounts shown include the revenue estimates as adopted by RTIC on December 13, 2005, and the cost of operating state government based on appropriations adopted by the 59th Legislature. Also included in this figure are estimated amounts by LFD staff for statutory appropriations and budgeted transfers. The figure does not include any amounts for special session proposals recommended by the executive.

2007 Biennium General Fund Balance In Millions	
Beginning Fund Balance	**$297.4**
Revenues	**3,139.7**
Available Funds	**$3,437.1**
Disbursements	
General Appropriations	2,640.5
Statutory Appropriations	269.3
Transfers	54.4
Miscellaneous Appropriations	5.4
Supplementals	38.3
Session Costs	10.2
Reversions	(18.4)
Totals Disbursements	**2,999.7**
Adjustments	**(12.0)**
Ending Fund Balance	**$425.4**
Governor Proposals	189.7
Ending Fund Balance With Proposals	**$235.7**

As the Figure shows, the 2007 biennium ending general fund balance is projected to be a positive $425.4 million before any executive proposals or initiatives are considered. It should be noted that this balance is based on anticipated supplemental appropriations of $38.3 million for fiscal 2007. The following provides a brief explanation of the potential supplemental funding needed for various functions of state government.

The Figure also shows the projected general fund balance when the executive proposals are included. The executive proposes to increase public school funding by $64.7 million in fiscal 2007 and to transfer $100 and $25 million to the teacher's and public employee's retirement systems respectively. When these amounts are included, the projected ending fund balance for the 2007 biennium is $235.7 million. If the legislature chooses to maintain an $80 million reserve, this still leaves $155.7 million available for legislative consideration.

Supplemental Appropriations

The following figure shows supplemental appropriations assumed in the disbursements.

Supplemental Appropriations FY 2007 (In Millions)	
Agency	Amount
DPHHS	$10.95
Corrections	22.00
Revenue	0.40
Sub Total	$33.35
Wild Fire Cost	4.90
Total	$38.25

Department of Public Health and Human Services (DPHHS)

DPHHS has three areas of current and/or potential cost overruns:

2. A change in the percentage of Medicaid benefit costs paid by the federal government from the level assumed by the 2005 Legislature due to an improvement in Montana's relative person income compared to the rest of the country
3. Cost overruns at the Montana Development Center due to the impact of vacancy savings and higher than anticipated provider rate increases
4. Higher than anticipated population at the Montana State Hospital

Costs could be as high as over $16 million or as low as under $6 million, depending upon cost mitigation opportunities. The estimate assumes the department will mitigate a portion of the cost overruns.

Department of Corrections

The Department of Corrections is currently experiencing higher population growth than assumed in the 2005 legislative session, exacerbated by increased utility, medical, extradition, IT, contract, and legal costs; and raises provided to department personnel. The current overrun is estimated at $13.6 million. This total would be offset by other funds within the department and from the personal services contingency account to a currently estimated total of $11.8 million. Because of limited other mitigation opportunities and the on-going nature of the population increases, the figure above assumes a continuing problem in FY 2007 for a total of $22 million over the biennium.

Department of Revenue

The Department of Revenue has identified a cost overrun for implementation of the Property Assessment Division computer system due to an initial error in cost calculations. The department will mitigate some of the costs, leaving a shortfall of $430,000.

Summary

In summary, if the RTIC revenue estimate recommendations were adopted by the legislature the general fund ending fund balance for the 2007 biennium would be $425.4 million. An ending balance in the general fund of $235.7 million would occur if the legislature adopts the executive's recommendations for public school funding and pension fund bailouts, $155.7 million above an $80.0 million ending reserve.

PROJECTED GENERAL FUND BALANCE

The Figure below shows the detailed general fund balance sheet based on present law revenues and disbursements, followed by a sub-table that shows the balance when the executive's proposals are included. The $80.0 million reserve is not shown in this table.

2007 Biennium General Fund Balance
Action By the 59th Legislature With Preliminary Fiscal 2005 and RTIC Revenue Estimates
In Millions

	Actual Fiscal 2004	Preliminary Fiscal 2005	Estimated Fiscal 2006	Estimated Fiscal 2007	Preliminary 2005 Biennium	Estimated 2007 Biennium
Beginning Fund Balance	**$43.065**	**$132.873**	**$297.440**	**$357.361**	**$43.065**	**$297.440**
Revenues						
Current Law Revenue	1,381.565	1,530.949	1,542.615	1,597.055	2,912.514	3,139.670
Legislation Impacts	0.000	0.000			0.000	0.000
Residual Transfers	0.000	0.000	0.000	0.000	0.000	0.000
Total Revenue	**$1,381.565**	**$1,530.949**	**$1,542.615**	**$1,597.055**	**$2,912.514**	**$3,139.670**
Total Funds Available	**$1,424.630**	**$1,663.822**	**$1,840.055**	**$1,954.416**	**$2,955.579**	**$3,437.110**
Disbursements						
General Appropriations	1,165.925	1,227.408	1,311.367	1,329.097	2,393.333	2,640.464
Statutory Appropriations	126.600	128.589	134.343	134.978	255.189	269.321
Local Assistance Appropriations	0.000	0.000	0.000	0.000	0.000	0.000
Miscellaneous Appropriations	1.866	4.469	1.521	1.804	6.335	3.325
Non-Budgeted Transfers	10.052	9.512	24.926	29.509	19.564	54.435
Continuing Appropriations	0.000	0.000	0.000	0.000	0.000	0.000
Supplemental Appropriations	0.000	0.000	0.000	33.450	0.000	33.450
Language Appropriations	1.372	0.350	1.700	0.000	1.722	1.700
Wildfire Costs	0.000	0.000	4.876	0.000	0.000	4.876
Feed Bill Appropriations	0.000	0.000	2.121	8.050	0.000	10.171
Carryforward Appropriations	0.000	0.000	0.336	0.000	0.000	0.336
Anticipated Reversions	(23.777)	(16.301)	(10.511)	(7.855)	(40.078)	(18.366)
Total Disbursements	**$1,282.038**	**$1,354.027**	**$1,470.679**	**$1,529.033**	**$2,636.065**	**$2,999.712**
Adjustments	(9.719)	(12.355)	(12.015)	0.000	(22.074)	(12.015)
Unreserved Ending Fund Balance	**$132.873**	**$297.440**	**$357.361**	**$425.383**	**$297.440**	**$425.383**
Governor Proposals						
On-Going for Quality Schools				31.168		31.168
One-Time for Quality Schools				33.500		33.500
Retirement Systems Infusion				125.000		125.000
Total Governor Proposals				**$189.668**		**$189.668**
Unreserved Ending Fund Balance With Proposals				**$235.715**		**$235.715**

2009 BIENNIUM OUTLOOK

The Figure to the right shows the projected general fund balance for the 2009 biennium. Amounts shown include the revenue estimates as developed by the LFD staff and the cost of operating state government based on present law requirements. Present law is statutorily defined as the additional level of funding needed to maintain operations and services at the level authorized by the previous legislature. These disbursement amounts are as estimated by the LFD staff. The present law amounts shown for both anticipated revenues and expenditures do not include any proposals or initiatives recommend by the executive.

2009 Biennium General Fund Balance In Millions	
Beginning Fund Balance	**$235.7**
Revenues	**3,293.4**
Available Funds	**$3,529.1**
Disbursements	
Present Law Costs	2,821.5
Statutory Appropriations	295.2
Transfers	19.9
Session Costs	10.0
Totals Disbursements	**3,146.6**
Ending Fund Balance	**$382.5**
Governor Proposals	62.4
Ending Fund Balance With Proposals	**$320.1**
Structural Balance Condition	
Revenues	**3,293.4**
Disbursements	**3,209.0**
Structural Balance	**$84.4**

As the Figure shows, the 2009 biennium ending general fund balance is projected to be a positive $382.5 million before any new proposals or initiatives are considered. This balance indicates the state can maintain the existing present level of services without a reduction in services or revenue enhancements. When the Governor's proposal for public school funding is included, the projected ending fund balance in the general fund is $320 million.

However, a positive ending fund balance does not necessarily indicate a structural balance or revenue sustainability. Structural balance is simply the balance of on-going revenues with on-going disbursements. If on-going revenues equal or exceed on-going disbursements, then structural balance is achieved. Conversely, if on-going expenditures exceed on-going revenues, then structural imbalance occurs.

As shown in figure X, the structural balance for the 2009 biennium is projected to be $84.4 million after funding the Governor's public school proposal. This means there would be $84.4 million or $42.2 million per year of on-going revenue to fund any other on-going proposals or initiatives.

The following is a list of potential funding needs in addition to public school funding not included in the above present law forecast. The legislature may wish to consider these issues in determining funding priorities for the 2009 biennium, for the immediate purpose of assessing sustainability of funding commitments that will be made in this special session.

- 2009 biennium negotiated state employee pay plan
- Pension funds unfunded liability permanent solution (e.g., employer rate increase, bonding, reduced benefit)
- Changes in FMAP (federal Medicaid match rate) due to change in state per capita income
- Human Services caseload/cost increases above projections
- Medicare Part D (prescription drug) federal cost recovery due to state savings ("clawback")

- Potential federal deficit reduction cutbacks in human services and other state programs (to the extent the legislature chooses to replace the cutbacks with state funds)
- State Fund "old fund" shortfall (current estimate is $14 million)
- Long Range Building Program deferred maintenance backlog on state buildings
- 2007 Biennium supplemental appropriations (on average, $30 million per biennium)
- Other new initiatives (new proposals historically have been $25 to $75 million per biennium, excluding pay plan)

There are also volatile areas in the revenue estimates that could result in significant swings in revenues, either up or down. These have been discussed previously in this report and include:

- A significant change in capital gains income - what level will be sustained over the long term?
- Oil and gas production/price levels – what level will be sustained over the long term?
- Calendar 2005 tax reform (rate reductions) – increased refund activity in Fiscal 2006?
- A significant change in corporate profits – what level will be sustained over the long term?

INDEX TO OTHER LFD BUDGET REFERENCE DOCUMENTS

In addition to this volume, there are several other LFD documents that legislators and other interested parties can use as a source of information concerning budget and other fiscal matters. A limited number of reports of past biennia are available for reference in the LFD office (photo copies of pages of interest can be made). Training publications and brochures are available for distribution and on the LFD website. Check with an LFD staff member for assistance.

LFD BUDGET ANALYSIS AND FISCAL REPORT

The *Legislative Budget Analysis* is prepared at the beginning of each biennium and the *Legislative Fiscal Report* is published at the end of each session. The latter is a record of legislative actions that resulted from the enactment of House Bill 2 and other appropriation legislation, as well as revenue estimation and discussion of other fiscal issues. Both publications are available on-line at: http://leg.state.mt.us/css/fiscal/reports.asp, and can be purchased through legislative printing.

Previous versions of the reports from 1979 onward are stored in the LFD office and the State Library. Reports from the 2000 Special Session onward are also available on-line at the above address.

SCHOOL FUNDING PRIMER

A primer on the current school funding system can be found in Volume 1 of the current Legislative Fiscal Report, available for photocopying in the LFD office and online at:
http://leg.state.mt.us/content/publications/fiscal/fr_2007/vol_1/ref_index.pdf

TRAINING PUBLICATIONS

Training material prepared by the LFD include the following:

- *Understanding State Finances and the Budgeting Process* (A Reference Manual for Legislators) is a helpful guide for persons wanting more detailed information concerning fiscal matters
- *HB 2 the Barbarian* (How to Make HB 2 Implement Public Policy as Determined by the Legislature) describes the intricacies of developing the general appropriations act

Both publications are available in the LFD office and online at:
http://leg.state.mt.us/css/fiscal/reports.asp#leg_reference

FISCAL POCKET GUIDES

A variety of brochures have been prepared to provide summary information concerning select topics important to legislators and other interested parties. The pocket guides are available at the entrance to the LFD offices, in the legislative library, and online at:
http://leg.state.mt.us/css/fiscal/reports.asp#leg_reference

- Basic State Finances
- General Fund Fiscal 2002, 2003, 2004
- State Employees
- Higher Education Funding
- Medicaid
- Montana Highway Funding
- Pertinent State Statistics
- Resource Indemnity Trust
- TANF (temporary assistance to needy families)
- Montana's Tobacco Settlement
- Montana's Budgeting Process
- Bed Tax
- Insurance Tax & License Fee
- Individual Income Tax
- Tobacco Tax
- Video Gambling Tax
- Cigarette Tax
- Wine Tax
- Liquor Excise Tax
- Beer Tax
- Corporation Income Tax
- Property Tax
- Coal Tax
- Coal Trusts

The LFD would welcome suggestions for other possible topics for pocket guides.

OFFICE OF THE GOVERNOR
STATE OF MONTANA

BRIAN SCHWEITZER
GOVERNOR

JOHN BOHLINGER
LT. GOVERNOR

TO: Members of the Montana Senate
Members of the House of Representatives
Secretary of State Brad Johnson
Members of the Montana Supreme Court c/o Clerk of the Court Ed Smith

STATE OF MONTANA
OFFICE OF THE GOVERNOR
PROCLAMATION

CALL TO THE 59TH LEGISLATURE
FOR A SPECIAL SESSION

WHEREAS, pursuant to Article V, section 6 of the Constitution of the State of Montana and § 5-3-101, MCA, the Governor may convene the legislature in special session; and

WHEREAS, pursuant to Article VI, section 11 of the Constitution of the State of Montana, the Governor may convene the legislature whenever he considers it in the public interest; and

WHEREAS, the Montana Supreme Court, in *Columbia Falls Elementary School District No. 6 v. State of Montana*, 2005 MT 69, held that Montana's system for funding its public elementary and secondary schools was unconstitutional in that the funding system was not based on a definition of a quality education and the requirement to recognize the cultural heritage of American Indians was not being fulfilled; and

WHEREAS, the 59th Legislature, through passage of Senate Bill No. 152 (SB 152), defined a "basic system of free quality public elementary and secondary schools," as required by Article X, section 1(3) of the Montana Constitution and the Montana Supreme Court's ruling; and

WHEREAS, the 59th Legislature, for the first time in Montana history, consistent with the Montana Constitution and the Montana Supreme Court's ruling, appropriated in excess of $3.4 million for the 2006-07 biennium to fund education related to the preservation of the distinct and unique cultural heritage of American Indians; and

WHEREAS, the 59th Legislature increased funding for Montana's K-12 schools by appropriating more than $88 million in new money for the biennium – an historic increase; and

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WHEREAS, the 59th Legislature, through passage of Senate Bill No. 525 (SB 525), established a quality schools interim committee to devise, by December 1, 2005, a funding formula for Montana's public elementary and secondary schools based on the definition of quality education enacted by the 59th Legislature; and

WHEREAS, the quality schools interim committee has accomplished the tasks assigned to it under SB 525, but has not agreed upon any one school funding formula; and

WHEREAS, in addition to the constitutional requirement that the legislature provide a basic system of free quality public elementary and secondary schools, Article VIII, section 9 of the Constitution of the State of Montana requires the state to maintain a balanced budget by directing that legislative appropriations not exceed anticipated revenue; and

WHEREAS, one component of a quality education system is the ability to recruit and retain qualified teachers, and in order to be able to recruit and retain qualified teachers, schools must be able to offer teachers competitive benefit packages; and

WHEREAS, Montana's teachers' retirement system currently has an unfunded liability exceeding $900,000,000.00; and

WHEREAS, Montana's public retirement system currently has an unfunded liability exceeding $500,000,000.00; and

WHEREAS, school boards are beginning the process of preparing their budgets for the 2006-07 academic year; and

WHEREAS, the regular session of the 59th Legislature completed its work in eighty-six days anticipating the likelihood of a special legislative session to enact a school funding system based on the definition of a quality education; and

WHEREAS, it is in the public interest of all Montanans that the 59th Legislature convene in special session to consider these matters.

NOW, THEREFORE, I, BRIAN SCHWEITZER, GOVERNOR OF THE STATE OF MONTANA, pursuant to the authority vested in me by the Constitution and laws of the State of Montana, do hereby convene the Fifty-Ninth Legislature in special session, in Helena, at the Capitol, at the hour of 9:00 a.m., the 14th day of December, 2005, and hereby limit the special session to the following subjects:

1. Legislation to enact a funding system for Montana's public elementary and secondary schools that is based on the definition of a quality education contained in SB 152 and that recognizes the cultural heritage of American Indians, in compliance with Article X, section 1 of the Montana Constitution and in fulfillment of the requirements of

the Montana Supreme Court's decision in *Columbia Falls Elementary School v. State of Montana*, and that also remains within a balanced budget, as required by Article VIII, section 9 of the Montana Constitution;

2. An appropriation for the funding system enacted by the Legislature in special session in compliance with the Montana Constitution and the Supreme Court's holding;

3. An appropriation of one-time money from the general fund to Montana's public elementary and secondary schools for recognition of the cultural heritage of American Indians and to address the following needs of schools: facility studies, weatherization for long-term energy savings, deferred maintenance, and assistance with utility and transportation energy costs;

4. An appropriation of $100 million from the general fund to the teachers' retirement system to both reduce the unfunded liability of the system and to help improve Montana's ability to recruit and retain qualified teachers;

5. An appropriation of $25 million from the general fund to the public retirement system to help reduce the unfunded liability of the system;

6. LC 2006-2, approved by the State Administration and Veterans' Affairs Interim Committee on November 30, 2005;

7. An updated revenue estimate requested by the revenue and transportation committee;

8. Confirmation of the chief water judge and the workers' compensation judge, as required by § 3-1-1013, MCA;

9. Confirmation of the governor's vacancy appointment of the director of the department of public health and human services; and

10. Any appropriations necessary for the operation of the special legislative session.

IN WITNESS WHEREOF, I have hereunto set my hand and caused the Great Seal of the State of Montana to be affixed. DONE at the City of Helena, the Capitol, this 5th day of December, in the year of our Lord, two thousand and five.

BRIAN SCHWEITZER
Governor